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IMPACT OF THE ELIMINATION OF STATE AND LOCAL TAX DEDUCTION

HEARING

BEFORE THE

SUBCOMMITTEE ON FISCAL AFFAIRS AND HEALTH

OF THE

COMMITTEE ON THE DISTRICT OF COLUMBIA HOUSE OF REPRESENTATIVES

NINETY-NINTH CONGRESS

FIRST SESSION

ON

ADMINISTRATION'S PROPOSAL TO ELIMINATE THE STATE AND LOCAL TAX DEDUCTION AND ITS IMPLICATIONS FOR THE DISTRICT OF COLUMBIA

JULY 12, 1985

Serial No. 99-7

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HEARING ON THE ADMINISTRATION'S PROPOSAL TO ELIMINATE THE STATE AND LOCAL TAX DEDUCTION WITH PARTICULAR ATTENTION TO THE IMPLICATIONS FOR THE DISTRICT OF COLUMBIA

FRIDAY, JULY 12, 1985

HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON FISCAL AFFAIRS AND HEALTH,
COMMITTEE ON THE DISTRICT OF COLUMBIA,
Washington, DC.

The committee met, pursuant to call, at 9:50 a.m., in room 1310, Longworth House Office Building, Hon. Walter E. Fauntroy (chairman of the subcommittee) presiding.

Present: Representative Fauntroy.

Also present: Edward C. Sylvester, Jr., staff director; Julius Hobson, Jr., staff assistant; Donn G. Davis, senior legislative associate; and Shahid Abdullah, minority staff assistant.

Mr. FAUNTROY. The subcommittee will come to order.

On May 28, 1985, the President's tax proposals to the Congress for fairness, growth, and simplicity was submitted to the Congress. The tax simplification plan would establish three tax rates for individuals ranging from 15 percent to 35 percent of taxable income, as opposed to the current 14 rates which would range from 11 percent to 50 percent to 33 percent of taxable income, as opposed to the current 46-percent rate paid by all businesses.

The net effect of the plan, according to Department of Treasury estimates, would be to decrease individual taxes by 5.2 percent and increase business and corporate taxes by 22.5 percent by 1990.

The lowered rates for both individuals and businesses would be countered by the elimination of certain deductions which are supposed to render the plan revenue neutral.

While the administration's tax proposals cover a 461-page volume, no single item has received as much attention as the proposal to repeal the deduction for State and local taxes.

Under the current law, individuals who itemize are permitted to deduct certain State and local taxes including: State and local real property taxes; State and local personal property taxes; State and local income taxes; and State and local general sales taxes.

According to the administration, States with high tax rates are subsidized by States with lower tax rates under the current Tax Code, and the deduction provides an incentive for these States to raise their revenues. The administration claims that repeal of the

State and local tax deduction is projected to generate $33.8 billion in revenues for 1988.

Although media attention has been focused on New York, and particularly New York, a congressional research service study, which I am submitting for the record, shows that District taxpayers who itemize would actually pay more in taxes under the Reagan proposal.

I am also submitting two newspaper articles on the subject, articles which suggest that such a deduction would make local and State taxes more expensive, and therefore force higher income taxpayers to seek residence elsewhere, shrinking the tax base in the District of Columbia, and thus creating a need to raise more taxes from those who are left behind. So we have resolved to take a careful look at this whole matter as it relates to the District of Columbia.

[The information follows:]

CONGRESSIONAL RESEARCH SERVICE,
THE LIBRARY OF CONGRESS,
Washington, DC, May 22, 1985.

To: Joint Economic Committee. Attention: Scott Lillie, Staff Director.
From: Dennis Zimmerman, Specialist in Public Finance, Economic Division.
Subject: Tax Reform Proposals and State-local Tax Deductibility.

You requested estimates of the effect of the three major tax reform proposals' treatment of nonbusiness State-local tax deductions on the Federal revenue gain and the State-local revenue loss. The memorandum is divided into four parts. The first section discusses the three reform proposals and explains how deductibility affects the State-local sector. The second section discusses the data and assumptions used to make the estimates. The data and assumptions are very important in interpreting the results, and should be carefully reviewed. The third section presents State-by-State estimates of the Federal revenue gain and State-local revenue loss. Section IV discusses some of the different effects the three proposals can be expected to have on the State-local tax structure.

Tax reform and deductibility

The Treasury, Bradley-Gephardt, and Kemp-Kasten tax reform proposals eliminate the deductibility of some or all State-local taxes. The Treasury proposal would eliminate deductibility for all State-local taxes; the Bradley-Gephardt, proposal would eliminate the deductibility of sales and personal property taxes, while allowing continued deductibility for income and real estate taxes; and the Kemp-Kasten proposal would allow only real property taxes to be deducted.

The importance of deductibility is that it lowers the cost of a dollar of State-local tax by the taxpayer's marginal tax rate (MTR). For example, a taxpayer with a 25 percent MTR actually pays $1 (1–0.25) = $0.75 for each one dollar of State-local payment. In addition, the taxpayer's after-tax income is higher by $0.25 for each dollar of State-local tax because of this saving on his Federal tax. The taxpayer is expected to respond to this lower cost (or price) and higher income by choosing to consume more State-local goods. This means the taxpayer is willing to pay more State-local taxes.

Given the importance of the taxpayer's Federal MTR to his decision concerning the amount of State-local taxes he is willing to pay, the three tax proposals' treatment of the Federal tax rate structure is at least as important as the deductibility of each tax in determining the expected change in State-local revenues. The Treasury proposal would narrow individual rates from the current 11 to 50 percent to a range of 15 to 35 percent; Bradley-Gephardt would narrow the range to 14 to 30 percent, but require all State-local tax deductions to be taken at 14 percent; and the Kemp-Kasten proposal would impose a 20 to 28 percent range.

The combined effect of the disallowance of deductibility and the reduction of marginal tax rates would be to raise the price of a dollar of State-local tax and provide an incentive for State-local taxpayers to lower their State-local tax payments. These proposals might also have several other effects. First, deductibility lessens the effective degree of progressivity in State-local income tax structures because effective marginal tax rates (statutory tax rates adjusted for Federal tax savings) rise less

steeply than statutory marginal tax rates. These proposals might lead governments to reduce the degree of progressivity in statutory rate structures. Second, deductibility may influence the choice among alternative State-local revenue sources if all such major tax sources are not deductible, because net prices would then differ among those types of taxes. And third, deductibility narrows effective interjurisdictional tax differentials and may influence fiscal competition among the States and localities.

Data and assumptions

The estimates presented here make several assumptions which are important to the results. First, it is assumed that a 10 percent increase in the cost of a State-local tax dollar causes the taxpayer to reduce his State-local tax payments by 5 percent. Second, the estimates are based on 1980 tax data. The Economic Recovery Tax Act of 1981 (ERTA) instituted an approximately 25 percent tax rate reduction, to be fully effective by 1984. The estimates in the memorandum assign 1984 tax rates to 1980 income data. The resulting tax rates are a little low because no account is taken of the income growth which would move some taxpayers to higher tax rates in the ERTA rate structure. Third, one must assume something about which State-local taxpayers control the State-local political process. Only taxpayers who itemize deductions on their Federal returns will experience a price increase from the limitation of deductibility and the reduction of MTRs. Non-itemizers, who represent roughly two-thirds of taxpayers nationally, will continue to have a price of $1 for each dollar of State-local taxes. These estimates assume that itemizers control the political process, and, therefore, must be seen as maximum estimates of the reduction in State-local tax revenues. To the extent non-itemizers have a say in the political process, because their price change is zero they will not have the price incentive to reduce taxes. And fourth, the tax reform proposals all include a substantial element of base broadening. Since many State and local income tax systems use the Federal income tax base as a beginning point in their tax calculations, the State-local tax base is broadened automatically. This would have the effect of increasing State-local tax revenues unless tax rates are reduced or tax bases broadened. No account is taken of this phenomenon.

Estimates

Table 1 provides estimates of the increased Federal tax liability per itemizing household (actually per itemizing tax return). The first column measures the dollars of State-local tax deductions which were itemized on Federal individual income tax returns in 1980. Columns 2 through 4 estimate the percentage of these 1980 deductions which would not have been allowed were the Treasury, Kemp-Kasten, or Bradley-Gephardt proposals in force in 1980. Column 5 estimates the average marginal tax rate for taxpayers itemizing State-local taxes. Each taxpayer's marginal tax rate (MTR) is weighted by his dollars of tax deductions. Columns 6 through 8 present the increased Federal tax liability per itemizer (per itemizing return). The Federal revenue gain is greatest for the Treasury proposal and smallest for Bradley-Gephardt.

The expected reduction in the State-local sector's revenues is presented in graph 1. These estimates assume that State-local tax itemizers control the political process. The effect on State-local revenues is determined by the proportion of previously deductible taxes disallowed by each reform proposal and the change in the itemizers' marginal tax rates, both of which contribute to an increase in the price of a tax dollar. The marginal tax rate utilized in calculating the pre-tax reform price is slightly lower than the MTR reported in table 1. What we are concerned with here is the MTR of each itemizer involved in the political process. The MTR is calculated by weighting each joint return MTR by two (for two voters) and each single return MTR by one (for one voter). This weighting scheme (rather than the dollars of deduction weighting scheme) produces somewhat lower MTRs (a national average of 0.23 rather than the 0.27 in table 1).

Based on graph 1, had any of the three reform proposals been in effect in 1980, deductible taxes would have decreased by 12.8 percent (Treasury), 8.7 percent (Kemp-Kasten), and 6.8 percent (Bradley-Gephardt). This is not, however, equivalent to saying that State-local revenues or State-local spending would have been lower by these percentages.

It is important to recognize that the dollar value of nonbusiness State-local taxes deducted by individuals on their Federal tax returns represents less than 15 percent of the revenue spent by State-local governments in fiscal year 1980. Although the cost to State-local taxpayers of these deducted taxes would have risen substantially, the cost of the remaining 85 percent of State-local revenue would not have been affected (at least by tax reform). For this reason, it is useful to estimate the percentage reduction in State-local own taxes and general revenues. Many State-local taxes

are not itemized on Federal tax returns. Some of these taxes are eligible for deduction, but the taxpayers do not itemize on their Federal tax returns; others are paid by business, and are still eligible for deduction under all three proposals. And some State-local taxes do not qualify for deduction—primarily excise taxes such as those on cigarettes, liquor, and gasoline. In addition, some State-local revenue comes from non-tax sources, such as user charges, fees, licenses, and Federal grants and revenue sharing.

The effect on the State-local sector is greatly diminished by considering the broader revenue base. Graph 1 suggests State-local general revenues (the most comprehensive measure of State-local revenues) would have decreased in 1980 by 1.5 percent (Treasury), 1.0 percent (Kemp-Kasten), and 0.8 percent (Bradley-Gephardt).

Table 2 provides similar estimates to those in graph 1 on a State-by-State basis. It must be emphasized that just as there is considerable variation in the estimated effects among the States when compared to the national average, so is there likely to be considerable variation among the governmental units within any State when compared to the State average. This variation depends upon the proportion of the jurisdiction's taxes and revenues being disallowed a deduction, and the marginal tax rates of its taxpayers.

Effects on the tax structure

The effect on State-local tax structures would be expected to vary across proposals. Since the Treasury plan disallows all State local tax deductibility, no incentives are created to switch from one tax source to another. The Kemp-Kasten plan allows only the real property tax to be deductible. This is primarily a local tax, and could provide some incentive to local governments to utilize property taxes more heavily. States should not be influenced. The Bradley-Gephardt bill allows both property and income taxes to be deductible. States could have an incentive to utilize income taxes more intensively relative to the general sales tax. This incentive is lessened somewhat by the requirement that all State-local tax deductions be taken at a 14 percent marginal tax rate. Since the average marginal tax rate for itemizers is currently considerably greater than 14 percent, the tax price reduction to be switch to income taxation is considerably lessened. Finally, the Kemp-Kasten bill could provide some incentives to transfer fiscal responsibility to local governments from State governments in order to take advantage of the lower tax price for property taxes, as an alternative to the States beginning to tax property to raise revenue.

All three proposals would increase the effective degree of progression in State-local tax structures and would create an incentive to reduce the progressivity of statutory rate structures. Bradley-Gephardt would have the least effect in this regard because it allows income taxes (thought to be the most progressive State-local taxes) to be deductible. Net interjurisidictional tax differentials would also widen, and could worsen the effects of tax competition among the States.

TABLE 1.—TAX DEDUCTIONS DISALLOWED AND FEDERAL TAX INCREASE PER ITEMIZER, ALTERNATIVE REFORM PROPOSALS, 1980

[Column 1—millions of dollars; columns 2-8—actual numbers]

[Prepared by Congressional Research Service]

State	Total State local deductions	Percent disallowed by Treasury	Percent disallowed by Kemp-Kasten	Percent disallowed by Bradley-Gephardt	Average marginal tax rate	Itemizer tax rise Treasury	Itemizer tax rise Kemp-Kasten	Itemizer tax rise Bradley-Gephardt
U.S. total	69,404.277	100	68.8	19.7	0.27	658.12	461.24	109.27
Alabama	659.453	100	89.5	33.6	.25	395.45	348.45	116.36
Alaska	98.720	100	55.0	18.5	.31	493.38	265.67	69.20
Arizona	739.110	100	76.5	31.7	.25	435.73	335.41	122.31
Arkansas	305.506	100	80.7	21.8	.27	446.73	367.97	80.46
California	11,064.109	100	79.7	23.3	.28	780.40	632.78	138.81
Colorado	1,101.204	100	71.0	22.8	.26	551.69	398.82	114.13
Connecticut	1,088.707	100	50.0	29.2	.30	737.87	378.32	174.26
Delaware	231.047	100	82.0	2.9	.31	918.13	760.64	13.94
District of Columbia	332.342	100	80.5	11.0	.31	1,017.40	826.14	89.73
Florida	1,185.252	100	41.5	31.5	.27	317.86	130.02	91.83
Georgia	1,224.082	100	76.4	21.6	.27	544.87	421.00	101.46
Hawaii	440.347	100	83.7	18.3	.27	744.23	622.77	115.54
Idaho	225.536	100	75.9	14.3	.24	489.16	381.19	60.35

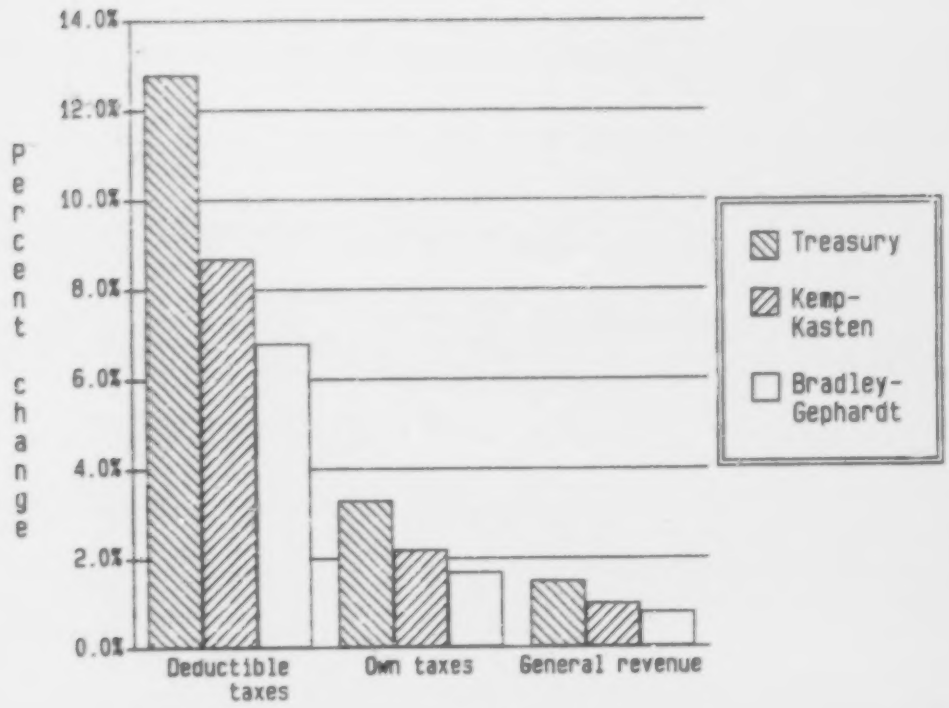
TABLE 1.—TAX DEDUCTIONS DISALLOWED AND FEDERAL TAX INCREASE PER ITEMIZER, ALTERNATIVE REFORM PROPOSALS, 1980—Continued

[Column 1—millions of dollars, columns 2–8—actual numbers]

[Prepared by Congressional Research Service]

State	Total State local deductions	Percent disallowed by Treasury	Percent disallowed by Kemp-Kasten	Percent disallowed by Bradley-Gephardt	Average marginal tax rate	Itemizer tax rise Treasury	Itemizer tax rise Kemp-Kasten	Itemizer tax rise Bradley-Gephardt
Illinois	3,410.435	100	58.4	22.2	.27	600.55	359.09	124.30
Indiana	830.185	100	72.6	32.1	.26	382.25	277.99	112.85
Iowa	758.129	100	70.1	14.5	.27	575.80	416.22	71.70
Kansas	534.728	100	70.8	21.5	.27	538.11	392.55	102.56
Kentucky	724.438	100	81.4	21.7	.26	537.01	428.84	96.69
Lourisiana	367.739	100	89.5	50.9	.28	276.00	239.75	121.95
Maine	218.870	100	63.8	18.7	.25	608.06	412.95	97.97
Maryland	2,200.516	100	72.8	13.2	.27	856.83	632.61	95.11
Massachusetts	2,855.646	100	57.9	13.0	.26	884.24	534.42	96.20
Michigan	4,041.799	100	59.3	13.4	.26	762.56	456.56	87.75
Minnesota	1,867.964	100	79.8	11.3	.27	803.43	648.03	75.94
Mississippi	297.173	100	83.0	39.9	.25	396.96	330.89	137.92
Missouri	961.370	100	71.7	25.2	.27	481.21	349.48	109.87
Montana	171.522	100	66.1	10.9	.25	437.26	298.68	38.71
Nebraska	402.150	100	64.3	20.0	.27	634.03	428.10	110.82
Nevada	126.930	100	47.6	36.6	.24	260.26	121.25	84.23
New Hampshire	184.708	100	29.7	7.6	.26	494.95	153.00	27.07
New Jersey	3,050.250	100	50.5	14.9	.28	800.76	414.04	95.32
New Mexico	203.100	100	76.9	30.4	.27	414.31	326.50	106.31
New York	10,820.293	100	71.4	14.0	.29	1,168.06	868.77	142.71
North Carolina	1,328.588	100	81.3	17.1	.27	603.73	488.78	83.94
North Dakota	83.054	100	54.2	17.3	.25	356.32	201.76	54.69
Ohio	2,231.270	100	69.6	20.8	.27	497.88	350.11	93.29
Oklahoma	575.054	100	79.7	26.5	.28	471.90	377.72	102.88
Oregon	1,001.826	100	69.3	2.0	.26	644.24	461.88	5.66
Pennsylvania	3,035.115	100	64.2	16.3	.26	619.44	398.09	88.43
Rhode Island	302.856	100	61.8	20.2	.27	777.31	488.13	118.02
South Carolina	671.974	100	83.6	22.1	.25	485.13	408.98	95.04
South Dakota	67.695	100	37.5	32.7	.23	325.25	123.86	104.14
Tennessee	403.005	100	59.6	48.3	.26	290.50	170.12	129.75
Texas	1,556.524	100	41.1	36.8	.28	327.96	128.50	112.97
Utah	469.074	100	74.2	25.3	.23	472.49	358.70	107.10
Vermont	121.034	100	61.9	10.7	.27	711.91	448.86	51.49
Virginia	1,731.210	100	73.9	19.5	.27	679.90	507.03	115.98
Washington	684.668	100	54.8	46.7	.25	328.04	175.58	146.26
West Virginia	181.597	100	88.7	21.4	.30	486.43	430.40	84.37
Wisconsin	2,075.884	100	68.0	10.2	.26	800.71	562.98	72.42
Wyoming	50.577	100	66.0	57.7	.26	229.06	150.41	127.47

Graph 1. Reduction in State-Local Tax Revenue from Alternative Tax Reform Proposals' Treatment of State-Local Tax Deductibility: Itemizer Control of the Political Process



Alternative Measures of State-Local Revenue

prepared by congressional research service

TABLE 2.—PERCENTAGE REDUCTION IN STATE-LOCAL REVENUE FROM ALTERNATIVE TAX REFORM PROPOSALS' TREATMENT OF STATE-LOCAL TAX DEDUCTIBILITY, 1980

[Itemizer control of the particular property]

State	Deductible taxes			Base taxes			General revenue		
	Treasury	Bradley-Gephardt	Kemp-Kasten	Treasury	Bradley-Gephardt	Kemp-Kasten	Treasury	Bradley-Gephardt	Kemp-Kasten
Alabama	11.9	7.0	10.6	2.5	1.4	2.2	0.9	0.5	0.8
Alaska	16.1	10.2	10.3	.5	.3	.3	.2	.1	.1
Arizona	11.6	6.7	8.6	2.9	1.6	2.1	1.3	.7	1.0
Arkansas	11.4	5.7	9.0	2.1	1.0	1.6	.8	.4	.6
California	12.3	6.7	9.7	4.2	2.2	3.3	1.8	.9	1.4
Colorado	12.2	6.5	8.5	4.2	2.2	2.9	1.9	1.0	1.3
Connecticut	13.9	8.8	7.4	3.7	2.2	1.9	2.2	1.3	1.1
Delaware	13.5	6.2	11.2	4.3	1.9	3.5	1.9	.8	1.5
District of Columbia	14.3	7.7	11.8	3.8	1.9	3.1	1.7	.9	1.4
Florida	12.5	7.5	4.6	1.6	.9	.6	.7	.4	.2
Georgia	12.5	6.8	9.5	3.0	1.6	2.2	1.3	.7	1.0
Hawaii	12.9	6.9	10.8	3.9	2.0	3.2	2.2	1.1	1.8
Idaho	11.2	4.8	8.1	3.1	1.3	2.2	1.3	.5	.9
Illinois	13.5	7.8	8.1	3.1	1.7	1.8	1.7	.9	.9
Indiana	12.6	7.7	9.1	2.1	1.2	1.5	1.0	.5	.7
Iowa	12.5	6.2	8.6	2.9	1.3	1.9	1.3	.6	.9
Kansas	12.8	7.0	9.0	2.6	1.4	1.8	1.3	.7	.9
Kentucky	12.5	6.8	10.2	2.9	1.5	2.3	1.3	.6	1.0
Louisiana	12.7	9.2	11.4	1.0	.7	.9	.4	.3	.4
Maine	11.9	5.9	7.2	2.2	1.0	1.3	1.1	.5	.6
Maryland	13.4	7.0	9.9	5.5	2.8	4.0	2.6	1.3	1.9
Massachusetts	12.6	6.2	7.1	4.3	2.0	2.3	2.3	1.1	1.3
Michigan	13.1	6.7	7.8	4.6	2.2	2.6	2.1	1.0	1.2
Minnesota	12.7	6.1	10.1	4.6	2.1	3.6	1.9	.9	1.5
Mississippi	12.0	7.6	9.8	1.8	1.1	1.5	.7	.4	.5
Missouri	12.6	7.1	9.0	2.8	1.5	2.0	1.3	.7	.9
Montana	11.7	5.1	7.3	2.1	.9	1.3	1.0	.4	.6
Nebraska	12.4	6.5	7.7	3.0	1.5	1.8	1.4	.7	.8
Nevada	11.9	7.3	4.9	1.6	.9	.6	.7	.4	.3
New Hampshire	12.7	5.8	3.1	2.9	1.3	.7	1.5	.6	.3
New Jersey	13.7	7.4	7.1	4.2	2.2	2.1	2.2	1.1	1.1
New Mexico	12.1	7.0	9.1	1.5	.9	1.1	.5	.3	.4
New York	12.9	6.6	9.7	4.5	2.2	3.1	2.3	1.1	1.6
North Carolina	12.3	6.2	10.0	3.2	1.5	2.5	1.4	.7	1.1
North Dakota	12.1	6.0	6.1	1.4	.7	.7	.5	.2	.2
Ohio	13.0	7.2	9.1	2.8	1.5	1.9	1.3	.7	.9
Oklahoma	12.4	7.0	9.8	2.1	1.1	1.6	1.0	.5	.8
Oregon	12.0	4.7	8.0	3.8	1.4	2.5	1.7	.6	1.1
Pennsylvania	12.9	6.7	8.2	2.9	1.4	1.8	1.5	.7	.9
Rhode Island	12.6	6.7	7.6	3.4	1.7	2.0	1.7	.8	1.0
South Carolina	11.8	6.0	9.7	3.0	1.5	2.4	1.3	.6	1.1
South Dakota	11.3	6.4	2.9	1.2	.6	.3	.5	.3	.1
Tennessee	12.4	8.7	7.2	1.3	.9	.7	.6	.4	.3
Texas	14.0	9.4	6.1	1.4	.9	.6	.7	.4	.3
Utah	10.5	5.1	7.2	3.6	1.7	2.4	1.5	.7	1.0
Vermont	12.8	6.2	7.8	2.8	1.3	1.6	1.3	.6	.8
Virginia	13.1	7.2	9.8	4.1	2.2	3.0	2.0	1.0	1.4
Washington	13.1	9.3	7.2	1.9	1.3	1.0	.8	.5	.4
West Virginia	13.7	7.9	12.3	1.4	.8	1.2	.6	.3	.5
Wisconsin	12.1	5.4	8.0	4.3	1.9	2.8	1.9	.8	1.2
Wyoming	13.1	10.1	8.7	.7	.5	.5	.3	.2	.2

Prepared by Congressional Research Service.

[From the Washington Post, May 29, 1985]

Tax Rise Here Would Exceed U.S. Average: Study Shows D.C. One of the Hardest Hit

(By Marget Engel)

Federal income taxes in the District of Columbia, Maryland and Virginia would increase more than the national average if a Treasury Department proposal to drop deductions for state and local taxes is enacted, according to a Congressional Research Service study.

The District would be hardest hit, as the study shows that only New York State would exceed the District in tax increase under the proposal.

"The District is one of the biggest losers because it's got relatively high income taxes and high sales taxes, which would cease to be deductible," said an aide to Sen. Daniel P. Moynihan (D-N.Y.), who is fighting to retain the deduction. "Even if the overall rate were reduced as a result, 16 states and the District would pay more in taxes."

The 44 percent of D.C. household that itemize taxes would pay $1,433 more in federal taxes, according to the study. A Maryland family that itemizes would pay $1,207 more if the deduction for state and local taxes were dropped. A Virginia household that itemizes would pay $958 more, compared with a national average of $927 if the longstanding deduction is eliminated.

Dropping the deduction may cause District officials to decide to raise the city's tax rate, according to City Council member John W. Wilson (D-Ward 2), chairman of the council's Finance and Revenue Committee. "We've always felt this idea would be a problem for us," he said. "We've had tax increases for the last seven years and . . . I was hoping we didn't have to do one this year."

Even though fewer than half of District households itemizes taxes, "they're the ones who make the money in the District," Wilson said. "Income tax is our biggest moneymaker."

Education groups are lining up to keep the deduction, saying that its elimination will most directly affect local property taxes on which schools depend for support.

"Education is the last public service that voters have a say over because they can affect the property tax rate," said Greg Humphrey, legislative director of the American Federation of Teachers and spokesman for the Coalition to Defend Education's Tax Base, an organization of 15 national education groups.

"We've estimated that eliminating the deduction will cause a $16.5 billion price increase in education at the state and local level," Humphrey said. "This is the kind of price tag that states can't swallow."

Larry Hunter, research director of the Advisory Council on Intergovernmental Relations, an independent federal research office, said local officials are worried about ending the deduction because "they will have to be on the firing line for every tax dollar."

He added, "You're pulling away a federal subsidy of education."

Wilson said that "so far, all I'm getting are calls about business lunches and vacation homes. But when people realize that any sizable loss caused by this plan has to be made up with new taxes my phone will be ringing off the hook."

The Joint Economic Committee has scheduled hearings today and tomorrow on the impact of eliminating the deduction.

[From the Washington Post, June 3, 1985]

D.C. Resident Tax Reform's Biggest Losers: Changes Would Force City to Revamp Code

(By Rudolph A. Pyatt Jr. and Albert B. Crenshaw)

The Reagan administration's proposal to eliminate state and local income taxes as deductible items on federal income tax returns would force the District of Columbia to restructure its tax system, according to local officials and municipal finance experts.

If the controversial deductibility provision is approved, several officials said, the District—like New York City and other large urban centers of the Northeast—will be under tremendous pressure to cut services drastically or to try to raise taxes in an environment that makes it much, much more difficult politically to do so.

Under the president's tax simplification plan unveiled last week, the federal government could be expected to raise about $34 billion in 1988 by eliminating the deduction for state and local income taxes. In jurisdictions such as the District where high-income taxpayers—who are more likely to itemize—pay relatively high state and local taxes, the federal tax write-off helps make the total burden of taxes more tolerable.

Approval of the provision eliminating the deduction could have a "devastating" effect on the District's ability to raise revenue, according to D.C. City Councilmember John A. Wilson (D-Ward 2), chairman of the council's committee on finance and revenue.

"There is absolutely no question that the District will have to restructure its tax code totally," agreed Philip M. Dearborn, vice president of the Greater Washington Research Center and former financial counselor to D.C. Mayor Marion Barry.

D.C. officials declined to speculate on the need to raise taxes if the proposal is approved. Officials have begun to assess the city's options under several scenerios, however.

While eliminating the state-tax deduction would badly hurt the District by widening the tax gap between the city and the suburbs, other tax-reform provisions could harm Maryland and Virginia as well. The services industry—increasingly important to the local economy—would be particularly hard hit. The tax-reform proposals:

Could push down long-run residential and commercial property values in the city by giving new arrivees in the area added incentive to buy property in the suburbs.

Would reduce tax revenue from hotels and restaurants—a large source of local funds—by limiting the deduction for business entertainment and meal expenses.

Would hamper cash flow at law firms, medical organizations and other service providers by requiring many companies to use the "accrual basis" of accounting, which reports and taxes income when earned instead of when actually received.

District residents with high incomes generally pay higher federal and local income taxes than suburban residents, and with the loss of deductibility, Dearborn predicted, "there will be a greater incentive for those people to relocate" to the Marland and Virginia suburbs. And, he said, any significant flight of D.C. residents to avoid higher taxes will lower the demand for property in affluent areas of the city and, thus, depress values and reduce the real property tax base, reducing the city's tax base by another notch.

"I'm more worried about the migration than anything else, frankly," Wilson said. "The problem is, we're already in a terrible competitive position with Maryland and Virginia, and if you drop the deductible, we're really in trouble."

Wilson predicts the loss of deductibility—which, in effect, is a subsidy for states—"will make local officials all over the country make some hard decisions.

"I would assume that New York City and Washington would find it very difficult" to manage without deductibility, Wilson speculated, because "we're surrounded by suburban jurisdictions which tax less because they don't have to do as much. We have more poor. We have more police, a complicated educational system, and all these things eat up money. The cities are basically trapped."

Similar stresses will be felt by cities across the country, even those in low-tax regions, according to economists and lobbyists concerned with the issue, because almost all cities impose higher taxes than surrounding jurisdictions.

"This is one of those issues where 90 percent of cities will say it will have an adverse impact, even in the Sun Belt," said one.

The plan would intensify not only city-suburb rivalry but also competition between adjacent high-tax and low-tax states for both jobs and tax-paying residents.

John Gunther, executive director of the U.S. Conference of Mayors, noted that, based on current tax burdens, the president's plan would set, for example, New York against Connecticut and New Jersey, Michigan against Indiana, and Ohio against Kentucky and West Virginia. With its very low taxes, "West Virginia would make out like a bandit," possibly drawing from Virginia, Ohio and Pennsylvania, he said.

Unlike most cities, however, the District has a narrow commercial base, "and that bothers me," Wilson acknowledged. "We can't go absolutely crazy on [raising] our commercial property taxes because they create the little bit of work we do have other than government."

In effect, eliminating the deduction for state and local taxes could create a relentless cycle for jurisdictions like the District with relatively progressive tax rates. Making local taxes more expensive by eliminating the deduction, if it forces high-income taxpayers out, shrinks the tax base and creates the need to raise taxes for those who are left.

"We would be in a position where we would almost have to raise taxes," Wilson said, But, he added, "It will be very difficult to convince people you have to raise taxes when they can't deduct them."

Upper-income taxpayers in high-spending cities or states with relatively progressive tax structures gain the most from deductibility, the Advisory Commission on Intergovernmental Relations noted in a 1984 report. In 1980, for example, D.C. taxpayers who itemized on their tax returns received the highest benefits from the deduction for state and local taxes—an average of $917 in federal tax savings—of any state, the commission said in a report entitled "Strengthening the Federal Revenue System: Implications for State and Local Taxing and Borrowing."

The commission added that voters who itemize are more likely to support or tolerate higher spending by local government than they might otherwise because deductibility has the effect of increasing their income and reducing the net prices they pay for state and local services. "What's more, the commission said, elected officials, "may be more apt" to propose tax hikes since they realize that, with deductibility, the net additional tax payment is less than the actual proposed increase for many voters.

The deductibility provision can either reduce the incentive for outmigration or encourage immigration into relatively high-spending and high-taxing jurisdictions, depending upon how taxpayers value the expenditures funded by state and local taxes, the commission said.

A study completed last month by the Congressional Research Service calculated that the average itemizing taxpayer in the District would lose $1,017 if his ability to deduct local taxes were lost. The impact of this tax increase is second only to New York's average loss of $1,168, and ranks well ahead of the $856 that would be lost by a Maryland taxpayer, and $679 by a Virginia taxpayer.

In addition, the study found that the average D.C. itemizer is in the 31 percent bracket, compared with 27 percent in both Virginia and Maryland.

The elimination of deductibility "would be a temptation for all state and local jurisdictions to increase taxes," observed Robert S. Statham, a local tax lawyer and former chairman of the Greater Washington Board of Trade's tax committee. By the same token, Statham added, "I think that if the District loses some people as a result of [the loss of deductibilty], it will wind up taxing those who stay."

But according to William R. Brown, director of finance for Prince George's County, the loss of deductibility may not necessarily mean a big outmigration and erosion of the District's tax base.

"On the other side of the coin, you have to look at the reduction in the [federal] tax rate," Brown said. "With a [projected] maximum tax rate of 35 percent, the deduction could wind up costing [a taxpayer] less. And there may be some cases where an individual might pay more, but I don't know if it's worth moving because it might take several years to recover the expenses of selling a house and moving to another jurisdiction."

On the other hand, Brown added, if real property taxes go up significantly over two to three years, taxpayers might have concern about the loss of deductibility and resist tax increases. And that, Brown added, has significant implications for elected officials.

The big concern Wilson and other D.C. officials have is that the individual income-tax burden in the District is the most progressive—the higher one's income, the higher the relative tax burden—in the area. As an example, in the District, the tax burden is 2.70 percent of income at the $10,000 income level, and 7.28 percent at the $75,000 income level. In Virginia, income at the $10,000 level is taxed at 1.75 percent, and 3.95 percent at $75,000. In Maryland, the least progressive of the three jurisdictions, the burdens are 3.23 percent and 5.44 percent at the $10,000 and $75,000 levels, respectively.

Should the loss of deductibility create an incentive for high-income taxpayers to move to jurisdictions with lower taxes, then the District will be put in the position of having to shift some of the tax burden from the higher income group to other taxpayers, Dearborn said.

COMPARISON OF STATE-LOCAL TAX BURDENS BEFORE DEDUCTIBILITY, 1980

	Adjusted Gross Income of:		
	$9,000–$12,000	$26,000–$30,000	$100,000, and over
District	$690	$2,366	$20,701
Maryland	1,195	2,699	15,191
Virginia	758	2,208	11,76

Source: Advisory Commission on Intergovernmental Relations

Dearborn, coincidentally, is preparing a position paper on what the District needs to do about its "out-of-line" tax-rate schedule. "The end result, I think, is there will have to be a total restructuring of the District's taxes," he said. "And that's not a very pleasant prospect politically for District officials. But I don't think they will have much choice if the president's plan is approved."

The real estate industry in high-tax areas such as New York and the District also is beginning to worry about the impact of the proposal on property values, both residential and commercial. Several agents here, though reluctant to speak publicly of anything that might hurt house prices, said they fear that home buyers may become reluctant to look in the city.

"I don't see a great rush for the suburbs by people who are already here," said one. "You've got to remember that many of the better-off people who live in Northwest have been there a long time and have low-interest mortgages. Buying in the suburbs with a new loan might be more expensive than losing the deduction."

However, he added, when a new arrival is choosing among the local jurisdictions, the tax situation probably would be a major factor.

David Strachan, of the Washington Board of Realtors, said that while he has not analyzed the impact of the proposal, it would seem likely "to drive down values in the long run." He argued that "single-family homeowners are already subsidizing tenants" because rent control depresses the value of—and thus tax collections from—residential rental property. Loss of the deduction "would be another factor" raising homeowners' costs.

A decline in property values means a decline in a city's tax base, eroding the city's revenue. But raising taxes might simply increase the erosion in revenue by forcing people out.

"This isn't going to make life any easier," Gunther said.

Nor is life likely to get easier in other sectors of the local economy that could be significantly affected by other provisions in the president's proposal, several local business leaders said. However, businesses that don't require a lot of capital investment probably would fare better than those that do, said Stephen D. Harlan, managing director at Peat, Marwick, Mitchell & Co. "Washington is not a capital-intensive area, so we might fare better, simply because we have a higher percentage of the services industry than does the Midwest, for example," Harlan noted.

Indeed, the services sector has emerged as one of the mainstays—along with government—of the area's economy. The services sector accounted for almost 63 percent of the region's total employment growth between 1977 and 1981, according to a Greater Washington Research Center study.

But continued rapid growth in that sector could be adversely affected if certain provisions of the administration's tax reform proposal are approved, according to several local executives and tax experts.

Limiting deductions for business entertainment and meal expenses, for example, could have a rippling effect locally. "The hotel and restaurant industries are extraordinarily large segments of our economy and limiting those deductions could have some impact, but how much, I don't know," Harlan said.

"Certainly the expense-account restaurants will be hurt," said John Cockrell, executive vice president of the Restaurant Association of Metropolitan Washington. "Some restaurant operators are concerned they may have to lay off some employees.

Not only is there the potential for job losses but a decline in the restaurant industry's business-meal volume has some negative implications for the District's tax revenue. "It's a key industry and we have an 8 percent tax on meals," Dearborn pointed out.

In other segments of the service industry, cash flow could be affected by a provision that would require firms to use the so-called accrual basis of accounting when revenue exceeds $5 million. Under the accrual method, revenue would be reported and taxed when earned instead of when actually received. The impact of that could be extremely adverse for many law firms, accounting firms, medical service organizations, advertising agencies and other service providers, according to local tax experts.

Using the accrual basis would have a dramatic effect, not only for the service industry locally, but for the entire country according to Harry Linowes, managing partner at Leopold & Linowes, a Washington accounting firm.

"It means, in essence, that if you perform a service and bill a client and you aren't paid for six months or a year, you would actually have to pay taxes," Linowes said.

The bigger problem, Linowes said, is how a company should report work in progress. "You can realize the amount of hardship if you had to report income you haven't received and pay income tax on something you didn't receive.

"I would have to believe it will increase the need for borrowings, or a reduction in consumer spending, in that the partners in these firms will have less cash to spend for consumer items. That's going to have a significant effect on the economy."

Tax experts say the major local winner under tax reform could be the burgeoning high-tech industry concentrated in Northern Virginia and Montgomery County. High-tech firms now pay a much higher average corporate tax rate than other businesses—businesses—something the administration proposals would change.

Furthermore, the plan gives a three-year extension to tax credits for research and development and actually cuts the top capital gains rate from 20 percent to 17.5 percent. Industry official said, however, that it is not clear how much those benefits will compensate for the loss of investment tax credits and lengthening of the depreciation schedules for capital equipment investments—changes that the tax plan also includes.

Mr. FAUNTROY. Today the subcommittee will hear witnesses from the District of Columbia and the academic community on this important issue, one which is certainly going to claim the attention of the Congress intently over the next few months and perhaps over the next few years.

Before turning to our list of witnesses, I do want to submit for the record as well, the statement of the chairman of the House District Committee, Hon. Ronald V. Dellums, who says,

* * * for the record, I would like to submit both an observation and a strong opposition to that aspect of the administration's tax proposal, which would eliminate nonbusiness taxpayer deductions for State and local taxes. As is well known, this aspect of the proposal flies in the face of one of the stated goals of the administration's proposal, that of achieving fairness in the Tax Code.

With that opening paragraph, I want to submit for the record without ojection, in its entirety, the statement of Congressman Dellums.

[The prepared statement of Mr. Dellums follows:]

STATEMENT OF HON. RONALD V. DELLUMS

Mr. Chairman, for the record, I would like to submit both an observation and a strong opposition to that aspect of the Administration's tax reform proposal which would eliminate nonbusiness tax payer deductions for state and local taxes. As is well known, this aspect of the proposal flies in the face of one of the stated goals of the Administration's proposal, that of achieving "fairness" in the tax code.

Throughout the nation's most populous areas, that is our cities and metropolitan areas, middle income taxpayers would bear a disproportionate burden of the cost of eliminating the deductions for non-business state and local taxes. Representatives from large population centers in the Northeast and Midwest have indicated that the citizens of these regions would pay as much as 57 percent of the cost of eliminating

these deductions. Similar inequities emerge when one considers the burden that would fall on city dwellers around the country.

In no place would this inequity be more acute than in the city of Washington, D.C. which, for a number of reasons, is already seriously beset with problems related to raising revenue which would be exacerbated by the Administration's proposal.

District of Columbia taxes are among the highest of any city in the country, a fact which almost certainly mitigates against the attraction and retention of those taxpayers who are needed to support and maintain vital city services.

An unusually large segment of the District's population itemize deductions on their tax returns. Many of these are the same taxpayers who have been migrating from the city for the past decade and who are keenly aware of the extra tax burden borne by those who remain in the city.

Four years ago, during a series of hearings on urban problems, this Committee discovered that Washington—like a number of our cities—was becoming an unbalanced preserve of the wealthy and the very poor. This is an extremely unhealthy development which negatively affects every institution in the community, and the proposal to do away with the non-business tax deduction will further contribute to this problem. It will become extremely difficult to keep those middle income taxpayers in the city who constitute the backbone of the city's revenue system should the Administration succeed in abolishing non-business state and local tax deductions.

Then there is the general problem caused by the presence of the federal government, a limited ability to raise revenues by means common to other localities, and I am convinced that the current non-formula based federal payment completely offsets this loss. It certainly does not alter the loss suffered by the city as a result of the federal prohibition against any commuter tax being imposed by the city.

All of these problems, if further compounded by the abolition of non-business state and local deductions; and given the existing reality of drastic program cuts already made by the Administration against urban programs, will result in Washington, D.C. and other cities suffering a very serious blow to their development and general welfare.

This is not "fairness"; no "growth" could possibly result from such a policy, and it is altogether too simplistic.

Mr. FAUNTROY. May I also note that other members of the committee, particularly the ranking minority member, Mr. McKinney, will be late in arriving and will submit his statement upon arrival.

Let me note that we do have a very distinguished panel of witnesses, including our own Mayor and the chairman of the city council, and to set the tone for the hearing, and the subject which will claim our attention for the next few hours, let me first call upon Dr. Henry J. Aaron, who is, in addition to being the senior fellow, at the Brookings Institution, for Economic Studies, professor at the University of Maryland, and has done work, recently published, assessing tax reform, and this should be particularly helpful to us in setting the context for the hearing today on the impact of proposed deduction of State and local taxes on the situation in the District of Columbia.

Mr. FAUNTROY. Dr. Aaron, it is a real pleasure to have you, and we look forward to your testimony. We have it in its entirety, and you may proceed in whatever manner you choose.

STATEMENT OF HENRY J. AARON, SENIOR FELLOW, BROOKINGS INSTITUTION

Mr. AARON. Thank you, Mr. Chairman. I appreciate having been invited to testify here this morning, and I will submit my entire statement for the record. I would like to just summarize a few major points that I think makes this hearing and the subject of it a very appropriate one for inaugurating consideration in this committee of the tax reform proposal.

The reason I think it is appropriate and important is that the deductibility of State and local taxes raises a very difficult dilemma for the Congress in its deliberations about tax reform. On the one hand, it is I think, not an exaggeration to say that unless Congress obtains much of the revenue that the President estimates would be generated by repeal of the deduction, the entire personal income tax reform is very nearly impossible.

This is the major base-broadening revenue-generating provision, on the basis of which personal income tax rates are reduced and personal exemptions are increased. The only other provision in the personal income tax that might generate similar revenue would be curtailment of the deduction for mortgage interest expenses on primary homes, and notwithstanding the pros and cons on that issue, I don't notice any groundswell in Congress or elsewhere for tampering with that provision.

That means that a substantial amount of revenue has to be gotten from this particular provision, if the tax reform plan is to proceed, if personal income tax rates are to be reduced. But on the other hand this proposal abruptly to repeal the deduction of State and local taxes in full poses some major problems for State and local governments throughout the United States, not just for the State of New York or the city of New York, a point I will come back to at the end of my statement.

There is a strong case to be made that because many of the services of State and local governments provide benefits to people who live outside their borders, residents of other jurisdictions should help bear part of the cost of many of the services that State and local governments provide. The ideal instrumentality, if we were living in a well ordered world, for achieving this goal, would be a comprehensive and major system of grants-in-aid from higher level governments to lower level governments.

Some parts of our governmental system do have such grant-in-aid, but in many other areas, I think it is safe to say that we don't recognize the benefits of expenditures made by one jurisdiction on the residents of others. The standout area in which I think this is the case is the very important effect that education expenditures throughout the United States have on us all.

As a resident of the District, I care very much how much is spent on education, not just in the District but in Virginia and Mississippi and Texas and California as well, and yet there is no fiscal device to recognize my interest in what those governments spend to educate children and adults through their school, college and university systems.

In addition, such aid as we have been providing is in process of being curtailed under the pressure of the mountainous budget deficits that the Federal Government now faces, so we have this very difficult dilemma. On the one hand, some revenue from the present deductibility of State and local taxes really is necessary for tax reform. On the other hand, the President's proposal asks us to go cold turkey, repeal that provision completely and immediately, abruptly, at the very same time that the other instruments we have for recognizing the mutual interests we all have in what State and local governments do are being weakened and cut back.

The question is, is there any way to reconcile these conflicting objectives. I think the direct and obvious answer is there is no complete way of reconciling them, but there are ways of taking both objectives into account. In my statement, I suggest one approach for consideration by this committee and by Congress, and that is that deductibility of State and local taxes should be restricted. That deductibilty should be allowed only to the extent that State and local taxes exceed a stipulated fraction of adjusted gross income on each person's tax return.

A very, very rough estimate suggests that if people were allowed to deduct State and local taxes to the extent that they exceed 5 percent of adjusted gross income, one would obtain about two-thirds of the revenue that the President estimates complete repeal would generate, but at the same time one would retain deductibility to the last dollars spent by most taxpayers who now itemize, and hence this mutuality of interest that I have in what jurisdictions spend elsewhere would continue to be recognized on the last or the marginal dollar of expenditure.

This isn't a perfect solution by any means. I have prepared a table which I would be glad to submit to the committee. My statement suggests that I have already, and I will remedy that error promptly. I have prepared a table that indicates how the current deduction is distributed across income brackets, measured as a percentage of adjusted gross income.

To my surprise, it turns out that State and local taxes for those who itemize is a much larger fraction of adjusted gross income at the lower end of the income scale than it is at the upper end of the income scale, so for low-and moderate-income itemizers, this provision would retain a larger proportion of the current deductibility than it would at the very top.

The one final remark I would like to make concerns the reference that you made to statements that had been made, largely coming out of the administration, suggesting that the debate on whether deductibility of State and local taxes should be repealed is between New York and the rest of the Nation. I think that characterization of the issue is utterly nonsense.

The debate about deductibility of State and local taxes concerns how State and local taxpayers will pay for the taxes necessary to support the services that their governments provide, and it concerns the way in which those decisions affect residents of other States.

Rather than being in opposition to the interests of the other 49 States, the concerns I would suggest of New York are also the concerns of the residents of all of the other 49 States and of the District of Columbia, and that is a concern over trying to design a Federal system in which we pose to State and local governments incentives that lead them to make decisions about how much to spend and on what to spend that is in the interests not just of their own citizens but of the Nation as a whole.

Thank you very much.

[The prepared statement of Mr. Aaron follows:]

STATEMENT OF HENRY J. AARON*

Mr. Chairman and members of the subcommittee, thank you for the opportunity to testify before your subcommittee on President Reagan's proposal to eliminate deductibility of state and local taxes in the personal income tax on the possible impact of this change on the District of Columbia.

You have chosen for your hearings what I believe to be the single most important proposal for change in the personal income tax in the president's tax plan. It is important because it is by far the largest revenue-increasing personal income tax change that the president has proposed. Without the revenue from this provision, significant reduction in personal income tax rates or increases in personal exemptions would be impossible to achieve without cutting revenues. The only other tax change that could generate a similar amount of revenue would be curtailment of deductibility of mortgage interest.

But the president ruled off limits any change in the deductibility of mortgage interest on primary residences. And I have sensed no groundswell in Congress to get him to change his mind. In short, curtailment of deductibility of state and local taxes is the keystone of significant reductions in personal tax rates.

Yet the president's proposal to repeal deductibility of state and local taxes abruptly on January 1, 1986 poses some major problems as well. Strong arguments can be made that some of the costs of state and local services should be borne by people who live outside their borders. The arguments rest on the demonstrable fact that many state and local services provide benefits to people who live outside their borders. Expenditures to educate children in Mississippi, New York, or Oregon clearly affect my well-being as a resident of Washington, D.C. And decisions on education by the D.C. school board and city council clearly matter for Virginia, Maryland, and other states where many children educated today in the District will eventually live, work, and vote. If each of us does not pick up part of the cost of services that affect people who live elsewhere, all of us are likely to spend too little on education. Similar arguments can be made with respect to other state or local services, including police protection, health expenditures, or welfare outlays. We are just too mobile and interconnected a society to treat each jurisdiction as a fiscal island.

The foregoing line of argument points toward a system of grants-in-aid for higher- to lower-level jurisdictions. It does not however, point to the particular pattern of implicit grants expressed in deductibility of state and local taxes, a system under which the size of the implicit grant depends on how many local residents itemize their deductions and on what tax bracket they are in.

In a well-ordered world, a set of grants-in-aid would match benefits and costs of state and local services, and no deductions would be permitted for state and local taxes. In fact, our system of grants is far from ideal, and it is being scaled back because of large budget deficits. To deny completely the deductibility of state and local taxes at such a time places extraordinary burdens on states and localities. A fully persuasive case for the complete elimination of deductibility can be made, but only if it is linked to a reform and extension of certain grants-in-aid.

Since no reform or extension of grants-in-aid seems likely in the near future, we are faced with a set of conflicting goals. First, reductions in federal individual income tax rates cannot go very far unless deductibility of state and local taxes is reduced. Second, state and local taxes are a rather poor grant-in-aid program. But, third, the relative importance of deductibility to states and localities is growing as grants-in-aid are curbed.

These goals can be partially reconciled if state and local taxes remain deductible, but only to the extent that they exceed a stipulated fraction of adjusted gross income. If the ceiling above which deductibility would be permitted were at 5 percent of adjusted gross income, federal revenues would rise by roughly two-thirds of the amount the Treasury estimates revenues would rise from complete denial of deductibility of state and local taxes. Some citizens of all states would continue to be able to deduct part of their state and local taxes, although clearly the fractions would be larger in relatively high tax states. Table 1 shows the average ratio for deductions for state and local taxes to income by income class in 1982.

In conclusion, I would like to say a few words about how the president's plan will affect relatively high-tax jurisdictions, like the District of Columbia. States or localities may have higher-than-average taxes for one of two reasons: their citizens may

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want to consume larger-than-average quanities of goods customarily provided by government, or their jurisdiction may face larger-than-average problems of the kind most effectively solved by government. To the extent that taxes are high to meet the costs of richer-than-average tastes for goods whose benefits are entirely local, President Reagan is entirely right that citizens in each jurisdiction should pay for what they buy and not shift the costs to residents of other jurisdictions through deductibility. But to the extent that local or state jurisdictions are shouldering national or regional responsibilities, they should not have to bear the costs of such services without outside assistance. In the latter event, grants-in-aid are appropriate; if they are not provided, the services that provide national or regional benefits, such as education and public safety, are likely to be provide at suboptimal levels.

The District of Columbia is in a special position because it receives a payment from the federal government supposedly to pay for otherwise-uncompensated costs generated by the federal government. A grant of this type is helpful and appropriate. But it does not deal with the issue that I am addressing today—the spillover benefits that each jurisdiction provides to residents of other jurisdictions. The existence of such benefits requires that the cost of each additional dollar of expenditure be shared in part by residents of other jurisdictions; for only in this way can citizens of each jurisdiction face the right incentives.

Mr. FAUNTROY. I thank you, Dr. Aaron. I think you hit a home run on that testimony. In fact, I was a little disappointed when staff informed me that Hank was not coming but you were coming.

In a more serious vein, you mentioned in your statement the Federal payment to the District of Columbia, and I wonder if you have had an opportunity to assess what would happen if the administration's proposal became law, and what would be our relative position in our request for Federal payment.

Mr. AARON. That is a very good question. The Federal payment is intended to meet a particular purpose. It is a lump sum payment in recognition of the fact that the Federal Government generates certain expenses for which it does not reimburse the District, and indeed, in a major degree, reduces its tax rolls.

It seems to me that fiscal instrument and the problem that it is intended to solve is separate in a way from the function the deductibility of State and local taxes is meant to perform. The property tax rolls are shrunk. The District government has a number of expenses that it would not have, were the Federal Government not here, but in addition to that, the District school board decides on how much to spend to educate the child of the District of Columbia. The last dollar spent on that education comes out of the pockets of residents of the District of Columbia through property taxes and perhaps from other sources as well.

The real point about the deductibility provision or that a well developed system of grants-in-aid would recognize is the point that when the school board votes on how much to spend on education, it is making a decision that affects residents of other States, and in the cost of which residents of other States should share in some degree, so I think that there is a case for the Federal payment, and there is a case for the mutual recognition through our fiscal system that each of us is affected by decisions made elsewhere.

The District would be hurt, I believe, by repeal of deductibility, and if deductibility were repealed, I think it would be in an enhanced position to argue for increased assistance through the Federal payment.

Mr. FAUNTROY. I have been concerned from the outset that this proposal would create a double whammy on certain States and cities like the District of Columbia, which have far more services

for a number of reasons with which you are all familiar, and I wonder what your assessment of the impact of New Federalism, which is cutting Federal aid to State and local governments at the same time that this second whammy of reducing both incentive to raise taxes at the State and local levels to breach that gap, and reducing in effect the tax base in the very areas where greater services are needed.

Have you done any assessment on what that combined impact would be on States generally and on the District of Columbia particularly?

Mr. AARON. Well, the cutbacks that are now occurring in grants-in-aid are the current expression or the administration's current response to budgetary difficulties. The New Federalism initially envisaged a swap in which income support activities would all be shifted back to States and localities, with no Federal cost sharing at all on the marginal or last dollars spent. I think that would have been a dreadful mistake.

The reason why I think that would have been a mistake is that as a Nation we may have views about how much we should assist low-income people directly through cash or inkind through health or food benefits that no jurisdiction could implement without fiscal support from outside. No jurisdiction would be able to implement them because they would justify my fear that high-income residents would flee and low-income nonresidents would come in, if their benefits got any higher than their neighbors. There would be a strong pressure for downward competition that would lead to a result different from that which people would support voting as a Nation.

In that area, it seems to me the New Federalism, the proper federalism, has to entail major support from the Nation to States and localities, if we are going to retain decentralized decisionmaking about welfare, Medicaid and such activities.

I am not necessarily defending our current welfare or Medicaid financing system, but I am suggesting it is nearer to what would be an optimal system than the system envisaged in the original new federalism proposal.

Mr. FAUNTROY. You suggest that the administration here would call for a cold turkey approach to the deduction.

Mr. AARON. Yes.

Mr. FAUNTROY. In your search for adjustments to the concept proposed, I wonder if you have thought of any triggers that might hold harmless communities like the District of Columbia which would be placed at a decided disadvantage with respect to their neighbors?

Mr. AARON. Let me say that, first, the reason I used the term "cold turkey" there is that this is the one area in the personal income tax proposals that I am able to identify where the administration's final proposal was tougher than the Treasury Department's November proposal. That proposal had a 2-year phase in, where half deductibility would be retained. That was gotten rid of in the final proposal, I think in order to make the books balance.

I think that those harmless provisions are difficult to design and sustain within the tax system itself. It would certainly not be a good idea to have a different tax law, a different Federal income

tax law, for residents of the District or New York or California than for Texas or Ohio or Illinois. We have to have a uniform national system.

Once again, if the District could show, over time, distress from the incentives resulting from repeal of deductibility, the District could make a case or try to make a case to Congress for a revision of the aid formula for the District.

One thing to keep in mind is that although repeal of deductibility would have an effect on residents of the District, it would have no immediate effect--I stress the word "immediate"—on the fiscal condition of the District itself. Repeal of deductibility does not reduce revenues to the District immediately, although as I am sure you will hear from Mayor Barry, it would change the environment drastically within which decisions are made about the tax levels that can be supported.

Mr. FAUNTROY. Dr. Aaron, I certainly appreciate the care with which you have prepared your testimony, and the candor with which you have answered the few questions I have tendered. I appreciate it.

Mr. AARON. Thank you very much.

Mr. FAUNTROY. With that background, let us now turn to our distinguished Mayor of the District of Columbia, Mayor Marion Barry, who I think can speak not only for the District of Columbia residents on this question but for many mayors of the cities around this country that would be impacted adversely by the deduction of State and local taxes, and particularly the members of the National Conference of Black Mayors.

Mayor Barry, it is a real pleasure to have you before the committee yet another time, and we are pleased with the fact that you bring your very able assistant Pauline Schneider to the witness table as well. We have your prepared testimony. We look forward to your statement.

STATEMENT OF MARION BARRY, JR., MAYOR, DISTRICT OF COLUMBIA, ACCOMPANIED BY PAULINE A. SCHNEIDER, DIRECTOR, OFFICE OF INTERGOVERNMENTAL RELATIONS

Mayor BARRY. Thank you, Mr. Chairman. Let me commend you for focusing on a very important subject as it affects the District of Columbia. Mr. Chairman, I appreciate very much your convening the subcommittee today to study the effects on the District of Columbia of the Reagan administration's proposed repeal of deductibility of State and local taxes.

Let me also say, Mr. Chairman, even though this is not the area that we are into, but let me add that the U.S. Conference of Mayors opposes this proposal; the National League of Cities, of which the District is a member of the advisory board, opposes this deductibility; also the National Conference of Black Mayors. So we are all together in this. But if we look at the District of Columbia, we look at the tax burdens and differences, the District is so unique in a sense that we are constantly competing with Maryland and Virginia for where people live. We are constantly trying to keep as many people in the District as we can, and attract additional residents to our city.

As you know, in the last 10 years there has been about a 14-percent decrease in the population of the District of Columbia, and taxes do mean a lot to some people. Of course, environment, the educational system, the price of a house or rental contribute to that, but certainly taxes is a major factor. So as Mayor of the District of Columbia, I would like to go on record as opposing this change.

The reasons are obvious. We have been told by the administration that most taxpayers will experience savings as a result of their proposed tax reforms. That is not so with respect to the District. The elimination of all State and local tax deductions will affect many taxpayers who itemize on their Federal returns.

Mr. Chairman, in 1983 there were approximately 319,000 tax returns filed in the District of Columbia. Nearly half of those filed were itemized deductions.

Mr. Chairman, the deductibility of State and local taxes from the Federal individual income tax has been a part of the U.S. tax system since the Federal income tax was established in 1913.

Also, Mr. Chairman, I would like to ask that my entire statement be entered into the record so we can deviate from it from time to time.

Mr. FAUNTROY. Without objection, it is so ordered.

Mayor BARRY. But D.C. residents stand to be severely affected by repeal of State and local tax deductibility—more than residents of any other State except one, New York—I repeat that—any other State except New York. Although figures from the administration would have taxpayers believe they would all benefit from enactment of the tax plan, those claims appear to be largely based on the estimates for single-earner families. In the District more than half of all taxpayers are single individuals, not single-earner families.

Mr. Chairman, in the District of Columbia when we look at our category of persons who file returns, let me just cite some figures to you for 1983. Out of the 319,000 tax returns filed in 1983, 158,000 of those were single individuals—158,000, which is a large number. In fact, it is more than half, which is not the typical kind of a State return that you have.

Also, Mr. Chairman, let me say that only 58,000 tax returns were persons who were heads of households. Those who were married and filed jointly, 31,000, and those who were married and filed separately, 9,000, and those who were married, combined and separate income taxes, 62,000. So we find here that the plan as proposed by the Reagan administration assumes that the majority of taxpayers would be families and senior wage earners. That is not true in the District of Columbia.

Also, Mr. Chairman, we have to be concerned about the impact of our taxing system on Maryland and Virginia, as I indicated earlier. Some States have moved toward increased reliance on user fees, but again the District is unique, as you very well know. We have a personal income tax, a property tax, and a sales tax. These three taxes alone represent about 75 percent of all of our local income. There is not much room for user charges.

Also, Mr. Chairman, we are in a very sensitive position because Washington, on the one hand, is blessed with an extraordinary

Federal presence which has important revenue implications for District finances. One of these revenue effects is a narrower property tax base because of the substantial amount of federally owned, tax-exempt property.

Fifty-five percent of all of the taxable land in the District of Columbia is owned by the Federal Government or foreign missions or other entities that are tax exempt, and therefore the District has great limitations on its local property taxes.

Also, Mr. Chairman, we can't tax non-D.C. residents who work here. We ought to. They use our streets and our standing police services and fire services and a number of other services.

Also, Mr. Chairman, we have height restrictions imposed by the Congress, as you know, which limits ability to build buildings of a certain height, which impacts on our property tax base. So our financial options are of limited flexibility. We must depend on a very narrow base to raise revenue.

Also, Mr. Chairman, as you mentioned earlier with the other witness, the District of Columbia has a disproportionate share of the poor in our region, a very, very disproportionate share of the poor, which means that we have to contribute greatly to Medicaid, Medicare, aid to families with dependent children, and other social services.

As you also know, Mr. Chairman, those areas are being proposed as being reduced. We have a severe housing problem in the District of Columbia, in the sense that almost 40 percent of our residents pay more than 35 percent of their income in rent, which is way above the national average.

Finally, Mr. Chairman, there may be other reasons to oppose these, but one reason that we cannot ignore is that if we take the current system—and I can give you some additional numbers—under the President's proposal D.C. residents currently, in terms of D.C. taxes, would be paying at $10,500, $279, and under the new proposal it would be zero. It goes right on down to $75,000. In each and every instance, Mr. Chairman, if the District continues its present tax laws, there would be an increase in taxes paid by D.C. residents.

For instance, the increase would range from 6.9 percent with an income of $10,500, to as high as 14 percent with an income of $27,000, which means the District would either have to allow its citizens to have this increased burden, and remain noncompetitive with Maryland and Virginia, or it would have to change tax laws to reduce this tax burden, thereby eliminating badly needed revenues. So we suffer on every account by these proposals.

Under the ideal situation—and we have mentioned it before at another hearing before this committee—if we were to eliminate the Federal income tax for D.C. residents, because we don't have representation, then we wouldn't be here talking about this subject. Those of us who live here wouldn't have to deduct anything because we wouldn't have to pay Federal income taxes, and I think that is a serious proposal we ought to look at.

Until we get representation, we shouldn't pay any Federal income taxes. Puerto Rico doesn't. They are American citizens. In light of the fact that we are paying, and we pay more Federal

income taxes per capita than all except one State, and that is Alaska, so they are very, very important to us.

I would urge, Mr. Chairman, as we look at this so-called reform, that we work awfully hard to eliminate this provision. It is estimated that about $34 billion would be gained by this. I don't think our cities in general, and the District of Columbia in particular, ought to suffer because of the abuses at the national level. I think our National Government is wasting billions of dollars in the Defense Department.

We all believe in a very strong defense, a national defense. We are paying $600 or $700 for an ashtray or a matchbox, whatever they buy over there. That hurts us, and if anyone wants to find $34 billion I think you know where you can find it, by certainly eliminating a few of those systems; the MX missile and a few others would get us $3 billion quickly, and not punish us.

Again, Mr. Chairman, I want to commend you for having this hearing, because I don't think our residents understand the severe impact of these proposals, and I am sure that our neighboring States of Maryland and Virginia—and you will hear witnesses later, Mr. Dearborn and others, who will say certainly make changes in their income tax laws, to lower their taxes to keep them in line. Thereby out of just sheer competitiveness the District will have to change its laws to lower this burden. We are among the highest taxes in the land already.

Again I want to thank you so much for this hearing. It puts on the record a very important subject. If you want to talk about winners and losers, the District will be one big loser. Maybe some other States will be winners, but we will be losers.

Mr. Chairman, we have lost enough in terms of our lack of voter representation and lack of ability to tax non-DC residents, our lack of ability to prosecute our own local crimes, our lack of ability to name our own local judges, our lack of ability to have you and others vote, so we have lost enough. Let's stop losing and let's win. We have lost our ability to be the final decisionmakers on our budget. I want to hit a home run on the other side now, and I think it is time we do that.

Thank you, Mr. Chairman.

[The prepared statement of Mayor Barry follows:]

STATEMENT OF MAYOR MARION BARRY, JR.

Mr. Chairman, I appreciate very much your convening the subcommittee today to study the effects on the District of Columbia of the Reagan administration's proposed repeal of deductibility of State and local taxes. Eliminating that deduction is described by the administration as key to its recently proposed "tax reform" bill. As Mayor of the District of Columbia, I would like to go on record as opposing this change. The reasons are obvious.

We have been told by the administration that most taxpayers will experience savings as a result of their proposed tax reforms. That is not so with respect to the District. The elimination of all State and local tax deductions will affect many taxpayers who itemize on their Federal returns. Nearly half of all District taxpayers—140,000 of a total of 310,000—filed itemized Federal returns in 1983.

The deductibility of State and local taxes from the Federal individual income tax has been a part of the U.S. tax system since the Federal income tax was established in 1913. Although some less important taxes such as State excise taxes are no longer deductible, four major types of State and local taxes have continued to be allowed as deductions in computing the Federal individual income tax—State and

local income taxes, real estate taxes, personal property taxes, and general sales taxes.

District of Columbia residents stand to be severely affected by repeal of State and local tax deductibility—more than residents of any other States except one, New York. Although figures from the administration would have taxpayers believe they would all benefit from enactment of the tax plan, those claims appear to be largely based on the estimates for single-earner families in the District more than half of all taxpayers are single individuals, not single earner families. Two earner-families also make up a significant proportion of the tax returns. The single earner family represents a small portion of District taxpayers.

There are other reasons why the deductibility of State and local taxes should be retained in the Federal Tax Code. Since the tax bases of State and local governments are much more constrained and limited than the Federal tax base, the increased Federal tax burden on many District taxpayers will make it more difficult for the city, if the need should arise, to raise the local income tax in the future. The repeal of State and local tax deductibility represents discrimination on the use of local revenue sources, and limits the local electorate's choices as to how public services should be funded, whether through taxes or user fees. An increased reliance on user fees would also increase the number of District residents who may not receive some very essential services—simply because they cannot afford to pay for them. The taxpayers of the District of Columbia have not yet made this choice.

The elimination of all State and local tax deductions would also exacerbate the tax rate competition among State and local governments. The District of Columbia, by virtue of its unique position, is very sensitive to fluctuations in this tax rate "equilibrium". Unlike the other States and cities throughout the Nation, Washington is "blessed" by an extraordinary Federal presence which has important revenue implications for District finances. One of these revenue effects is a narrower property tax base because of the substantial amount of federally-owned, tax-exempt property.

This situation is compounded by Federal actions which limit D.C. tax revenues. For instance, the Federal Government prohibits the District of Columbia from taxing nonresident income earned in the District, from levying real estate taxes against land and buildings held by foreign governments; or taxing personal property held by foreign governments. Congressional restrictions on the heights of buildings in the District further restrains economic development and limits District revenues. Because of this extraordinary Federal presence and restrictions on our taxing authority, the taxes which the District can levy are necessarily higher than those imposed in the region and nationally. In short, on a comparative basis, the tax burden on the District average taxpayer is high. Repeal of this provision would make the District appear less attractive as a place to live compared to Maryland and Virginia.

The District's financial options are of limited flexibility. We must depend on a very narrow base to raise revenue, we are prohibited by law from taxing the two-thirds of the income earned in the District by non-residents; we have a tremendous amount of tax-exempt land, both Federal or non-profit; the uniqueness of our Capital City status limits our growth and self-initiative; and we rely heavily on individual income taxes.

Yet there is another reason for retention of State and local tax deductibility its repeal would cause double taxation. Since 1913, as Federal income history shows, the basic premise has been one of taxpayer entitlement to the deduction of State and local taxes. This premise, grounded on traditional notions of fairness, is a primary ingredient in our Nation's Federal system of taxation. We are all citizens of the United States. State and local tax deductibility achieved "citizen neutrality" and left it to the individual States and localities to decide which taxes they would impose, and the level of those taxes. The latitude of those choices is borne out by the wide mix of rates, brackets, and personal exemptions employed by the 45 States which presently impose an individual income tax.

Finally, while there may be other reasons to oppose the repeal of the deductibility of State and local taxes, there is one reason which simply cannot be ignored. Elimination of all tax deductions at current Federal rates would increase Federal taxes on District residents in 1987 by an estimated $143 million. In essence, the District losers under the administration's proposal will be "big losers." A large number of District taxpayers who itemize returns will experience an increase in their federal income tax burden. These people already pay proportionately more in Federal taxes; under the proposal, however, they would pay even more.

By and large, in the case of the District, these are our middle-income taxpayers. These taxpayers already share a disproportionate tax load under the current law. Elimination of State and local tax deductibility would further increase their tax

load—an unwarranted and undesirable result when we think about the position which the middle class occupies in our Nation. The elimination of State and local tax deductibility is anti-middle class and anti-urban. Without a strong middle class, the financial future of urban America is jeopardized.

The public needs to have all aspects of the tax reform bill thoroughly aired and debated. Those large number of taxpayers who will not see lower taxes, and in fact will pay higher taxes, need to know that the "reform" or "fairness" or "simplicity" they hope to get may not be worth the costs.

Those of us who live and pay taxes in the District of Columbia stand to lose a good deal if this act, with this particular provision, is enacted by the Congress.

Mr. FAUNTROY. I thank you, Mr. Mayor, for as usual your cogent and perceptive remarks on a subject that is in this instance of national importance, but which has an impact upon us in the District of Columbia.

I have noted that in both your remarks and in Dr. Aaron's remarks efforts to assess what would be alternative means of meeting the need for filling the gap in terms of lost revenues. You have mentioned two of them, which I would like you to elaborate upon: One, the prospect of a user tax or user fees, and I wondered what your assessment of greater reliance on that mechanism would do to your effort to provide services here and to retain taxpayers.

Mayor BARRY. Mr. Chairman, unlike some cities or counties in States, our user fee base is very, very narrow. For instance, I guess one could consider our water and sewer charges as user fee, which we do have, but again we have to remain competitive in that area, and there is not much room there. We are constantly under pressure by EPA to improve Blue Plains, which we are doing, and we have a 5-year plan already to increase water and sewer rates, so that is not much there.

We charge people for driver's licenses, but again there is not much in there. That is just D.C. residents, 300,000 of them. I think the rate now is about $12. We charge people for permits. Again, there is not much in there. These are not big bucks. As I indicated earlier, 75 percent of our budget is in the local property taxes, income taxes, and sales taxes, so there is not much you can get.

I assume you could probably, if you stretched it and pushed it, $4 million or $5 million out of this, but there is not any room there for that. We can't erect toll bridges. We ought to but we can't—because Congress would get up in arms—at our borders, as New York State and New York City do, charging people for using our roads, which really is a user fee. So, we don't have that opportunity, so there is not much room there at all for user fees. In fact, some of our fees are rather high right now.

I just finished doing something which is very controversial, increasing the fees on vendors to $106. You know what that did in terms of all that controversy and all the political pressure we had, which wasn't easy but we had to do that, and a number of other fees. We have 130,000 professionals who are licensed in the District of Columbia. Again, we think their fees are appropriate at this time. We don't want to run them out of the city by raising user fees to the point that they practice their medicine or their nursing or architecture somewhere else, so that is not much in there at all.

Mr. FAUNTROY. Both your testimony and that of other witnesses suggest that the imposition of the deductions would result in our being at a competitive disadvantage with residential opportunities

in the suburban areas surrounding the District of Columbia, that many people would be tempted to leave. I wondered if you have any assessment, can provide us with an assessment, of what might be regained in terms of a commuter tax? That is, the President has suggested that there would be a savings of some $33.8 billion to the Federal Government if this deductibility were eliminated.

I wondered how much of that savings would come out of the hide of the District of Columbia in terms of a round figure, and second, how that would track with a reasonable reciprocal tax arrangement. If you don't have that kind of data readily available now, I would certainly be pleased for you to submit it after having staff analyze it.

Mayor BARRY. Mr. Chairman, as our best estimates, about $143 million would come out of the hide of D.C. residents in 1987.

Mr. FAUNTROY. Do we have any projected commuter tax or reciprocal tax proposals that would bring that much revenue in?

Mayor BARRY. Mr. Chairman, as you know, we have a 2-percent separate income tax before us. I have forgotten what it brings in, but the full reciprocal income tax would bring in about $700 million to the District of Columbia. We would like to supply the 2-percent rate to you a little bit later. But $700 million is the full amount, and obviously we would never propose the full amount——

Mr. FAUNTROY. No.

Mayor BARRY [continuing]. Of a reciprocal income tax, because obviously non-D.C. residents don't get all of the benefits of all of the services. On the other hand, I am tempted to propose it, because of the tremendous disparity in the burden of poverty that the District of Columbia shares with Maryland and Virginia.

Again, that is what we need to do in terms of reciprocal income tax, in terms of having one, whether it is 2 percent or 5 percent, but $143 million would be the number that we would be given of that $34 billion.

Mr. FAUNTROY. I would appreciate staff looking at that, because should this matter become one of serious import for the Ways and Means Committee of this House, I would certainly want to enlist their support for a measure, an alternative that would be viable for us. You have already ruled out the user fee increase as a means of filling that gap, and it may be that we have to seek seriously and with great determination a reciprocal tax based on the elimination of the prohibition of commuter taxes for our locally elected government.

Mayor BARRY. Mr. Chairman, let me add that this issue came before us at the Conference of Mayors in Anchorage, AK, just recently. We found that a number of States, particularly those States that have limitations on their property tax growth and other kinds of growth, the TRIM movement in Prince George's County and proposition 13 have had to resort to a user tax as a way of trying to make up lost revenue, and they have indicated even in those States that they are almost at the end of how far they can go with additional user taxes, user charges, so this is no solution.

As I said earlier, user charges, the theory of user charges is that those who use the service ought to pay for it, and those who don't should not. For instance, with our driver's licenses, those non-

drivers don't have to pay for a license tax. Those nonowners of automobiles don't have to pay that particular charge, or persons who are not professionals don't need a license to pay. That is the theory of user charges.

It would be unfair to impose an across-the-board user charge on someone who doesn't use the service, in that narrow sense of the word. So, again, I wanted to add that not only are we facing that problem here, not having much of a base to deal with, but States, counties, and cities around the Nation have the same problem. User charges is no substitute for the ability to deduct State and local taxes. This is fundamental.

In 1913, it seems to me that the U.S. Government has signed a pact with these States, counties, and cities. It ought not to break that pact. It ought to find this money someplace else. It ought to reduce this deficit some other way, and it ought to increase taxes some other way. As you know, a number of major corporations in this country earned millions of dollars and paid zero income taxes. There is a whole range of places I think that the U.S. Government ought to go after in terms of tax reform, but certainly not at the expense of our cities, our counties, and our States.

Mr. FAUNTROY. Finally, Mr. Mayor, there has been a great deal of discussion on the Hill here focusing on whether high tax areas would have to be drastically reduced in terms of the services they received in the District of Columbia and in other jurisdictions similarly situated. What do you feel would happen in the District of Columbia, in high tax areas, in terms of the level of services that you would be able to deliver compared to services elsewhere?

Mayor BARRY. Mr. Chairman, without quantifying it—we can do it for the record—I do know that we would have to reduce our taxes in order to compete with Maryland and Virginia, which means that we would have to reduce some services. There is no way you can get around that. With the shrinking of the Federal support to the District of Columbia, we have been very fortunate to have a great revenue growth for 1986, $159 million compared to the average of $70 million or $80 million of natural revenue growth. We have been able to launch a war on potholes.

We have been able to hire every youngster this summer who registered between the ages of 14 and 12, over 24,000, with about $9 million of our own local tax money. We have been able to do programs for our senior citizens, and obviously if we have to reduce our revenues, and with the growth of inflation, we are going to have to reduce services, there is just no question about that.

Mr. FAUNTROY. I thank you so very much, Mr. Mayor, for your testimony here. It may be very helpful. It, certainly, lays out a clear picture of the impact that this proposal would have on the District of Columbia. For that we are grateful.

Mayor BARRY. Thank you, Mr. Chairman.

Mr. FAUNTROY. I am very pleased now to welcome to the witness table to present the testimony of the distinguished chairman of the Council of the District of Columbia, David Clarke, his very able assistant, Mr. Rich Siegel. We are very happy to have you, Mr. Siegel. We recognize that Chairman Clarke's many responsibilities prevent him from testifying here in person at this time but we have his prepared testimony and we look forward to his testimony.

STATEMENT OF RICHARD SIEGEL, ASSISTANT TO DAVID CLARKE, CHAIRMAN, COUNCIL OF THE DISTRICT OF COLUMBIA

Mr. SIEGEL. Thank you, Mr. Fauntroy. On behalf of Chairman Clarke I want to express the gratitude in being able to come before this subcommittee. I am Richard Siegel, the budget director of the D.C. Council, and I am here to address the issue of the proposal to eliminate the deduction of State and local taxes from the Federal income tax and its possible impact on the District of Columbia on behalf of Chairman Clarke.

The President's worthy goals of fairness, growth, and simplicity are to be applauded, but are contradicted by his specific proposals, many of which would be especially noxious to the District. In particular, the elimination of the deduction for many State and local taxes could have a drastic impact on the District. For the more than 45 percent of District taxpayers who itemize their Federal tax returns—and who deduct local income, property, and other taxes—the Reagan tax proposal could be devastating. According to a study conduced by the Congressional Research Service, the average District taxpayer who itemizes would lose $1,017 through the elimination of the deductibility of city taxes.

Maryland residents would lose $856; and the average Virginia resident, $679. This change, in essence the very tax hike that the President has long promised to avoid, is bound to make the District a less desirable location for middle- and high-income taxpayers.

There is evidence to believe that the President's tax reform is being built on the backs of jurisdictions like the District of Columbia, which have a progressive tax system and a relatively large proportion of people in need of government assistance. The District's tax system seems to balance the taxpayers' ability to pay with the government's duty to care for the needy. What's troublesome about the President's proposal and ironic at the same time is that it follows on the heels of proposals to reduce funding of the major social, housing, employment, and health service programs that have benefited urban America.

State and local governments, like the District, which compassionately care for the needy, have reacted to these Federal cutbacks with increased local funding and many have utilized a progressive income tax system to do it. Now the President proposes to clamp the lid shut on those jurisdictions which have progressive taxing policies. How are we to maintain a fair and equitable revenue stream and care for those who need government's help the most if State and local taxes are no longer deductible?

The District's tax system has counted on State and local tax deductibility as an essential element of our taxing system. Yet the President's tax reform proposal gets its biggest revenue boost—as much as $33 billion—from the elimination of this provision. In fact, according to the U.S. Treasury, ending State and local tax deductibility is at the heart of the tax reform proposal, and it appears that the executive branch is planning to lobby hard to maintain the elimination of the State and local deductibility as the flagship of the President's proposal.

Some observers have overreacted to the tax plan and have asserted that the changes will create a mass exodus of the responsible members of our community.

Mr. Chairman, David Clarke does not readily accept that. The District would still have much to offer through its diversity, its concentration of services and amenities, and its proximity to places of work. However, the ramifications of the President's tax proposal are clearly serious. For these reasons, he urges you to support H. Res. 105, the McGrath resolution, and to oppose the President's tax plan, particularly the elimination of State and local tax deductibility.

That concludes Chairman Clarke's statement, and I would be available for questions, if you might have them.

Mr. FAUNTROY. Thank you so much, Mr. Siegel

The chairman has his fingers on the pulse of not only the sentiments and feeling of the members of the Council of the District of Columbia, but also I know on citizens generally, and I wondered if you would give us an assessment of what would be, from the chairman's perspective, the council's reaction to increased user fees and reduction in resources pursuant to such a proposal being implemented.

Mr. SIEGEL. I can answer the question. It is hard for me to speak on behalf of 13 members of the council. They haven't taken up the issue. But let me try to say this. User fees from I think the chairman's point of view would really be regressive, because the wealthy people, wealthy residents probably would be able to afford the user fee, and our lower income residents probably would not, and a user fee can't be on the basis of who could afford what, but on the basis of what the charge for the service is. So we would object to that as a way of bringing in additional income to the District.

Mr. FAUNTROY. And a reduction of resources generally available to the council, would that in your view appear to be an option that the council would accept, try to deal with?

Mr. SEIGEL. I think the council—should this proposal go through—the council obviously would have to come up with some solutions. The problem that we are going to have is that the solutions are not very reasonable for our city. We don't have a tremendous tax base. We don't have a large manufacturing community here, or as the Mayor previously said, a great portion of our land is occupied by nonprofit organizations or by the Federal Government or by embassies, and so the base really rests on the income that is produced in the city. With the current prohibition against a commuter tax, we are an island unto ourselves, and one that would not be a very desirable place to live.

Mr. FAUNTROY. When the proposal was first made in May, surveys conducted around the country suggested that most Americans supported generally the tax reform concepts of the President. In more recent months, weeks, as the details of the proposal have become more available and are more understood by citizens of the country, those polls have indicated an erosion of support for these tax proposals. I wonder if the chairman in your view has any feedback from citizens generally as to whether they would look favorably upon this aspect of the tax reform package, the elimination of the deduction of State and local taxes?

Mr. SEIGEL. We have had a number of inquiries and a number of letters that have come in to the chairman regarding this. I would say on balance the citizens that we have heard from are generally against it. The problem has been the publicity and the marketing of this by the Executive. It is a 400-plus page document, it is very complicated, and it is being billed as reform and as helping the average American. We don't think it is.

One of the things that we have looked at is the burden of the District of Columbia. Our citizens pay in Federal taxes close to $1 billion. Now there has been talk about States, some smaller States in effect in terms of income support supporting larger States, and that the larger States, the higher income States are getting subsidies from the small. We don't think that is true, in that the revenue stream that we get back from the Federal Government in terms of grants has been going down and doesn't nearly approach the $1.1 billion that our citizens pay in Federal taxes.

Mr. FAUNTROY. Thank you so very much.

Our next witness comes to us with a tremendous background in areas relating to public policy generally, and on the tax reform package in particular, from the Heritage Foundation. I am pleased to have Dr. Bruce Bartlett, who will testify, and I suspect, Mr. Bartlett, it will be a contrary view, which I welcome at the hearing of every committee of this House. Thank you.

STATEMENT OF BRUCE BARTLETT, SENIOR FELLOW, THE HERITAGE FOUNDATION

Mr. BARTLETT. Thank you, Mr. Chairman. There is no question that elimination of the deductibility of State and local taxes will have a profound impact on cities such as Washington. However, the entire impact will not be necessarily negative, and in any case, I believe that it's impact can be substantially mitigated by adopting some sensible policies.

The major impact, of course, will be to dramatically increase the burden of city taxes. As it now stands, D.C. residents pay one of the heaviest State and local tax burdens of any city in America. According to the Advisory Commission on Intergovernmental Relations, the per capita local tax burden in Washington was $1,945 in 1982, the most recent year available. This ranked the District third behind Alaska and Wyoming. As a percentage of personal income, taxes in Washington amount to 14.17 percent of income, ranking it fourth behind Alaska, Wyoming, and New York.

Of the 51 largest cities in the United States, Washington ranks 9th in its burden of taxes on a family earning $25,000 per year and 6th among families earning $50,000 per year. The personal income tax goes as high as 11 percent on those earning over $25,000. Only four other States have higher top rates. Of those, only New York's top rate begins at a lower income. Thus the ACIR has concluded that Washington's taxes are, in fact, 45 percent greater than its tax capacity, relative to the other 50 States.

Such an exceedingly heavy burden of local taxation would, no doubt, have caused a mass exodus of the city's most productive people long ago were it not for Federal deductibility. Federal deductibility effectively reduces the real burden of local taxes by an

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amount equal to one's Federal tax bracket. For someone in the 50 percent Federal tax bracket, in other words, the burden of their local taxes would fall by 50 percent, assuming they itemize. Conversely, elimination of Federal deductibility would raise the burden of local taxes in a similar fashion.

It is widely believed that such an increase in the real burden of State and local taxes will lead to heavy pressure to cut taxes and spending in the high-tax States and localities. This may be true, but it is, of course, problematic as to whether such spending or tax cuts will in fact take place. They are not mandated by the President's tax reform proposal and it may be, when combined with other features of the President's plan such as the reduction in Federal tax rates, that many people will not find themselves any worse off than they are now in terms of their total tax payments.

Before one can say with certainty that someplace like the District of Columbia will unambiguously be worse off under the President's proposal one would have to factor in all aspects of the proposal as it would impact on the particular mix of people, businesses and income levels within a given area. For example, the elimination of State and local tax deductibility will only affect those who itemize their Federal taxes.

This figure is estimated to be 37 percent of all taxpayers nationwide and about 39 percent in the District. It will also depend on the average Federal tax rate facing people in a given area, which is largely a function of the area's personal income. The average Federal marginal tax rate on those who itemize is 29 percent. For Washington it is estimated to be about 32 percent.

Putting these together one can calculate the amount of Federal income taxes which is saved by people in given areas due to deductibility of State and local taxes. The average tax savings was $410.21 for the United States as a whole in 1980. For Washington it was $916.74. This is the highest amount of actual tax savings recorded for any State.

What is the justification for changing this feature of the Tax Code? Basically, it is that States and localities ought only to provide those services which people are willing to pay for. By allowing deductibility, it in effect lowers the cost of delivering State and local government services below their actual cost. If, for example, everyone in the District were in the 50 percent Federal tax bracket and everyone itemized, then the District could provide them a dollar's worth of local government services for only 50 cents.

Various estimates have calculated that this implicit subsidy has caused total State and local government spending to be anywhere from 7 percent to over 20 percent higher than it would be in the absence of Federal deductibility.

What specific sorts of ways has this manifested itself? For one thing, it has tended to encourage wealthy people to abandon the District despite deductibility. Many of these people feel that rather than stay in the District and pay to send their children to private schools, which must be paid for in after-tax dollars, it is better to move to Montgomery or Fairfax County, where they feel they can obtain the same quality of education they could get from a private school, yet pay for it in before-tax dollars, as part of the property tax.

It also encourages States and localities to provide services which the private sector is perfectly capable of providing. Trash collection is a good example. In many areas of the country trash collection is exclusively a private sector service. But again, the cost must be borne in after-tax dollars. By having government provide this service, they can pay for it in deductible local taxes.

Not only does this encourage expansion of the government sector and stifle the development of private businesses, but it also promotes inefficiency. This is because a government could provide a service such as trash collection at a cost higher than the private sector at an after-tax cost, due to deductibility, which is still lower for the consumer. Hence, scarce resources are wasted.

This suggests that one important way States and localities can deal with the loss of deductibility is by privatizing and contracting out for government services. There are a number of studies on how this can be done and numerous examples from States and localities around the country and throughout the world where many services we have come to associate with government are delivered quite effectively and cheaply by private firms.

Another point which is worth keeping in mind when considering how to deal with the loss of deductibility is that enactment of the President's program will expand the base of taxation in those States and localities which use the Federal tax base for calculating taxes. In other words, the elimination to the extent that someplace like the District applies its rates to the Federal tax base, the elimination of the other deductions and credits and exclusions proposed in the President's reform will expand the tax base.

Therefore, with the same rates the District has now, it would take in more revenue. This can provide revenue with which to reduce State and local taxes and thereby mitigate the effects of losing Federal deductibility on the tax burden.

Some may still argue that the issue of deductibility is not an economic issue. That federalism demands the retention of deductibility. However, my observation is to those who make this argument, federalism is only a one-way street. They want State and local taxes to be deductible from Federal taxable income but they do not similarly allow Federal taxes to be deducted from State or local income for tax purposes. Only 14 States allow whole or partial deductibility of Federal taxes. The District is one that does not. Therefore, I believe that this is really a disingenuous rationalization for maintaining the status quo, not a sincere concern for the separation of powers.

One point I will make in conclusion that occurred to me during listening to the testimony is this issue of how badly off the District will be relative to Maryland and Virginia. And you have to keep in mind that the District's taxes are already higher than those in Maryland or Virginia, and yet you don't have this mass exodus, and the loss of Federal deductibility will affect those people who live in Maryland and Virginia as well.

We tend to talk about the loss of deductibility as though it affects only the District when in fact it affects every one in the United States. Therefore, the relative difference in tax burdens between the District and its local competitors will be exactly the same as it is right now.

[The prepared statement of Mr. Bartlett follows:]

STATEMENT OF BRUCE R. BARTLETT

Mr. Chairman, my name is Bruce Bartlett and I am a Senior Fellow at the Heritage Foundation in Washington, DC. It is a pleasure to be here today to discuss the impact of President Reagan's proposal to eliminated federal deductibility of state and local nonbusiness taxes on the District of Columbia.

There is no question that enactment of this proposal will have a profound impact on cities such as Washington. However, the impact will not necessarily be negative and, in any case, it can be substantially mitigated by adopting sensible policies.

The major impact, of course, will be to dramatically increase the burden of city taxes. As it now stands, DC residents pay one of the heaviest state and local tax burdens of any city in America. According to the Advisory Commission on Intergovernmental Relations, the per capita local tax burden in Washington was $1,945 in 1982, the most recent year available. This ranked the District third behind Alaska and Wyoming. As a percentage of personal income, taxes in Washington amount to 14.17 percent of income, ranking it fourth behind Alaska, Wyoming and New York.

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Such an exceedingly heavy burden of local taxation would, no doubt, have caused a mass exodus of the city's most productive people long ago were it not for federal deductibility. Federal deductibility effectively reduced the real burden of local taxes by an amount equal to one's federal tax bracket. For someone in the 50 percent federal tax bracket, in other words, the burden of their local taxes would fall by 50 percent. Conversely, elimination of federal deductibility would raise the burden of local taxes in a similar fashion.

It is widely believed that such an increase in the real burden of state and local taxes will lead to heavy pressure to cut taxes and spending in the high-tax states and localities. This may be true, but it is, of course, problematic as to whether such spending or tax cuts will in fact take place. They are not mandated by the President's tax reform proposal and it may be, when combined with other features of the President's plan such as the reduction in federal tax rates, that many people will not find themselves any worse off than they are now in terms of their total tax payments.

Before one can say with certainty that someplace like the District of Columbia will unambiguously be worse off under the President's proposal one would have to factor in all aspects of the proposal as it would impact on the particular mix of people, business and income levels within a given area. For example, the elimination of state and local tax deductibility will only affect those who itemize their taxes. This figure is estimated to be 37 percent of all taxpayers nationwide and about 39 percent in the District. It will also depend on the average federal tax rate facing people in a given area, which is largely a function of the area's personal income. The average federal marginal tax rate on those who itemize is 29 percent. For Washington it is estimated to be about 32 percent.

Putting these together one can calculate the amount of federal income taxes which is saved by people in given areas due to deductibility of state and local taxes. The average tax savings was $410.20 for the U.S. as a whole in 1980. For Washington it was $916.74. This is the highest amount of actual tax savings recorded for any state.

What is the justification for changing this feature of the Tax Code? Basically, it is that states and localities ought only to provide those services which people are willing to pay for. By allowing deductibility it, in effect, lowers the cost of delivering state and local government services below their actual cost. If, for example, everyone in the District were in the 50 percent federal tax bracket and everyone itemized, then the District could provide them a dollar's worth of local government services for only 50 cents.

Various estimates have calculated that this implicit subsidy has caused total state and local government spending to be anywhere from 7 percent to over 20 percent higher than it would be in the absence of federal deductibility.

What specific sorts of ways has this manifested itself? For one thing, it has tended to encourage wealthy people to abandon the District despite deductibility. Many of

these people feel that rather than stay in the District and pay to send their children to private schools, which must be paid for in after-tax dollars, it is better to move to Montgomery or Fairfax County where, they feel, they can obtain the same quality of education they could get from a private school yet pay for in before-tax dollars, as part of the property tax.

It also encourages states and localities to provide services which the private sector is perfectly capable of providing. Trash collection is a good example. In many areas of the country trash collection is exclusively a private sector service. But again, the cost must be borne in after-tax dollars. By having government provide this service, they can pay for it in deductible local taxes. Not only does this encourage expansion of the government sector and stifle the development of private businesses, but it also promotes inefficiency. This is because a government could provide a service such as trash collection at a cost higher than the private sector at an after-tax cost, due to deductibility, which is still lower for the consumer. Hence, scarce resources are wasted.

This suggests that one important way states and localities can deal with the loss of deductibility is by privatizing and contracting out for government services. There are a number of studies on how this can be done and numerous examples from states and localities around the country and throughout the world where many services we have come to associate with government are delivered quite effectively and cheaply by private firms.

Another point which is worth keeping in mind when considering how to deal with the loss of deductibility is that enactment of the President's program will expand the base of taxation in those states and localities which use the federal tax base for calculating taxes. On a static basis, therefore, such areas can expect to increase their tax collections as a result of tax reform. This can provide revenue with which to reduce state and local taxes and thereby mitigate the effects of losing federal deductibility on the tax burden.

Some may still argue that the issue of deductibility is not an economic issue. That federalism demands the retention of deductibility. However, my observation is to those who make this argument federalism is only a one-way street. They want state and local taxes to be deductible from federal taxable income but they do not similarly allow federal taxes to be deducted from state or local income for tax purposes. Only 14 states allow whole or partial deductibility of federal taxes. The District is one that does not. Therefore, I believe that this is really a disingenuous rationalization for maintaining the status quo; not a sincere concern for the separation of powers.

In conclusion, I strongly support this provision of the Reagan tax reform proposal; indeed, I would even support it without the offsetting benefits of lower tax rates. I submit for the record a fuller study I have made on this topic and I will be happy to take your questions.

Mr. FAUNTROY. I certainly want to thank you, Mr. Bartlett, for your testimony, particularly for the documentation really that we had not up to this point received of the impact of Federal deductibility on the revenues for the District of Columbia. I was particularly pleased to note that the ACIR has concluded that Washington's taxes are in fact 45 percent greater than the tax capacity really of the other 50 States. That information is very important to us.

As you noted from our hearing thus far, we have been searching for alternatives for revenues and for handling the services that would have to be delivered in spite of the reduction or the elimination of the deduction, and I am pleased to note that you have suggested privatization of certain services.

On the question of trash collection, for example, the fact that studies have not been conclusive in this area, what other services would you suggest might be privatized, and how much do you think we could save?

Mr. BARTLETT. I don't know enough about exactly what services are not currently provided by the private sector that are provided by government here in the District, but I can tell you this, that 35

percent of all local governments in the United States contract out residential garbage collection, 44-percent contract out commercial garbage collection, 42-percent contract out the operation and maintenance of bus systems, 80-percent contract out vehicle towing and storage, 35-percent contract out the operation of day-care facilities, and 30-percent contract out the operation of maintenance of hospitals.

I can provide for the record some additional detail on the types of services and the extent to which private firms provide these in various localities around the country.

Mr. FAUNTROY. We would be particularly interested in the savings effected through the privatization of these services, and that would help us to assess what might have to be done should such a proposal in fact become law.

[The information follows:]

[From the Wall Street Journal July 10, 1985]

TAX PLAN'S BOOST TO PRIVATIZING SERVICES

(By E.S. Savas)

Some state and local officials believe that President Reagan's proposal to eliminate the federal deduction for state and local taxes would cause painful reductions in local government services. No way. The impact on state and local services will be negligible, but the opportunity to actually improve services is immense.

Let's examine the implied scenario that leads to the gloomy forecast: A loss of deductibility will cause wealthy taxpayers in some states to pay more in federal income taxes. These taxpayers will successfully press for cuts in state and local taxes so that their total taxes—federal, state and local—will be as low as they were before the reform. Finally, the thinking goes, this loss of revenue for state and local governments must inevitably be translated into proportional reductions in services. This reasoning does not withstand even cursory inspection.

First, even if tax revenues were ultimately to decline in accordance with this unlikely scenario, the drop would be only a few percentage points. Localities survived quite nicely in California and Massachusetts despite much more traumatic cuts triggered by Propositions 13 and 2½.

More important is the simple acknowledgment that a reduction in revenue does not have to be witlessly accommodated by a corresponding reduction in services. Giving the taxpayers more for their money—by better management and increased productivity—is a vastly better alternative. In fact, state and local governments now have available a thoroughly tested technique that regularly produces productivity improvements in the range of 30% to 50%; privatization.

The evidence on privatization by "contracting out" is now overwhelming and is no longer a matter of serious debate. The only question is one of political will, and of following prudent and proper practices.

Careful studies involving hundreds of communities, in the U.S. and abroad, compared the relative efficiency and effectiveness of municipal agencies and private contractors in providing identical services. For example, Los Angeles County recently reviewed the cumulative results of its privatization program since 1979. It concluded that its 407 separate contracts cost only $92 million, whereas if county agencies had done the work directly, the cost would have been $143 million or 55% more.

A detailed analysis sponsored by the Department of Housing and Urban Development found that the cost of street construction by city agencies was 96% greater than similar work by contractors, and that municipal costs were greater by 43% for street cleaning, 73% for janitoral services, 56% for traffic-signal maintenance, and 37% for tree pruning. In each case there were no differences in quality. Only in payroll preparation were the costs equal.

The most studied municipal service is refuse collection. Nine independent, large-scale studies have been conducted by academics and by government agencies in the U.S., Canada, West Germany, Japan, and Switzerland. All concluded that municipal collection is significantly more costly than contract collection, by anywhere from 15% to 124%. Moreover, a citizen survey covering more than 8,000 randomly select-

ed households in 82 randomly selected cities showed greater satisfaction with private companies than with municipal agencies, for the same level of collection service.

International studies comparing public and private bus operations show the former to be 67% of 100% costlier than the latter, but no better or safer. (The public bus agency in Calcutta, India, employed a whopping 50 employees per bus, far more than the private bus lines in the same city.) In the U.S. an exhaustive review of 249 transit systems by researchers at the University of California at Irvine concluded that privately owned and managed bus systems were the most efficient.

Early results indicate that the private sector can do better in constructing and operating prisons, wastewater treatment plants, street lights and resource-recovery facilities. In support functions such as data processing, food service and audio-visual services, a recent analysis of 235 federal-agency contracts reported by the Office of Federal Procurement Policy showed that the cost of such work by government had been 38% higher than contract work.

A clear trend toward privatization is under way. A 1984 survey of 55 state and local highway officials by Roads magazine disclosed that, by a 2-to-1 ratio, the officials would be relying more on contractors and less on their own forces for road construction and maintenance because they "are convinced that the private contractor can do the job more cost-effectively than public crews and equipment can." More than 100 different municipal activities are now being provided by contract, ranging from adoption services to zoning control.

Simple pragmatism, not ideology, is the driving force behind contracting out of state and local services. Officials are learning that they can maintain and even improve services while reducing costs significantly, and today this is important from reelection—at least as important as patronage and swollen public payrolls were in earlier days.

The reason why privatization works so well is not that the people employed by government are somehow inferior to those employed by the private sector; they are not. It works because privatization offers choice, and choice fosters competition, which leads to more cost-effective performance. Contracting out means dissolving unnecessary government monopolies and introducing competition in the delivery of public services. The public benefits from this competition, provided that sound bidding, contracting and performance-monitoring procedures are employed.

Governments are responsible for deciding which services are to be paid for by the public, but they do not have to produce and deliver the services using government employees. In effect, privatization elevates each government agency to the same commanding position as a manufacturer who can decide whether to make or buy a component for the product he is assembling. The efficient manufacturer will maintain a competitive balance among his suppliers—including his own plant—to assure the best possible overall results.

Predictably, public-employee unions oppose contracting out and federal tax reform because they see an end to their cozy monopolies and a loss of jobs to their new competitors in the private sector. Ironically, these private workers are themselves often unionized.

State and local governments can take advantage of the climate created by the federal tax-reform proposal and budget reduction effort to introduce new and better ways to manage their own affairs. Privatization, with its amply demonstrated benefits, leads to a better division of responsibilities between the public and private sectors, and can bring better and cheaper services to the public.

The Heritage Foundation Backgrounder

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MUNICIPAL SERVICES: THE PRIVATIZATION OPTION

INTRODUCTION

Strong criticism of the Administration's New Federalism initiative has come from the nation's city officials. They assume that the transfer of many programs to the states, in the form of scaled down block grants, will mean less spending on urban areas. The usual response of city officials to funding cutbacks is to present local citizens with an unappealing choice: either put up with increases in local taxes or face drastic cuts in public services. Both alternatives pose political and economic risks. Politically, the mood of the country is still against tax increases; Propositions 2½ (Massachusetts) and 13 (California) still command large majorities in their favor. Yet citizens also tend to resist cutbacks in local public services. Unlike many federal government activities, they are generally not perceived as wasteful.

This dismal analysis of the situation overlooks another alternative--privatization. Here and there around the United States, cities have been discovering that public services do not necessarily have to be produced by government or paid for by taxes. Once the government-production/ tax-funding constraint is lifted, a whole range of possibilities for alternative service delivery opens up. And the evidence to date indicates that services provided via privatization are generally produced more cost effectively than services provided by tax funded local monopolies. Privatization, therefore, offers cities a way out of the dilemma posed by the New Federalism, and is an effective mechanism to allow cutting the size of the federal budget while maintaining--or even improving--the quality of many services at the local level.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

THE DILEMMA

To understand why the New Federalism proposals have been met with such cries of alarm from local officials, it is necessary to understand the extent to which local governments have become dependent on the federal government. Ever since the New Deal, local governments have relied on various forms of "intergovernmental revenue" for a significant fraction of their income. This fraction increased gradually from 1940 to 1970, growing from one quarter of local revenues to one third--an increase of 8 percent in thirty years. But during the 1970s, such aid leaped by another 7 percent, mounting to 40 percent of all local revenue.

As Table 1 reveals, the principal shift has been for outside aid to offset local property tax revenue. Whereas property taxes accounted for 54.5 percent of local government revenue in 1940 and remained in the 40 percent range throughout the 1950s and 1960s, they had shrunk to 30.7 percent in 1977, the year before Proposition 13 and subsequent grass-roots revolts against property taxes.

Table 1 combines federal and state aid to local governments into a single category. While it is true that the fraction of this total going directly from the federal government to local entities had grown from only about 5 percent in 1950 to 22 percent by the end of the 1970s, this figure by itself is not very meaningful because a large fraction of state aid to local governments also is federal in origin. From the local officials' viewpoint, what is most relevant is the total revenue available from outside sources. Direct aid from Washington is often preferred, since competing interests within the state do not then have access to the money. But New Federalism threatens the level of all nonlocal revenue.

President Reagan's New Federalism proposes to reduce, in absolute terms, the amount of federal aid that has been going to state and local governments. The original (February 1982) plan called for turning over sixty-one federal aid programs to the states, in five categories: education and training, social services, transportation, community development, and revenue sharing. Although the turnback of programs has been reduced in scope, real cuts in aid are planned. This small but definite reduction in the role and outlays of the federal government represents a dramatic reversal of the trend of the last forty years, and especially of the past decade.

Regardless of how the details of New Federalism are finally ironed out, it seems clear that cities are going to end up with significantly less outside aid over the next decade. Their direct federal aid via such categorical programs as social services and community development will be cut. And their state aid, much of it paid for with federal funds, will also shrink. Cities are faced, therefore, with a painful dilemma: Do they raise taxes or cut services? Either action is politically risky. Or will they

Table 1
Trends in Local Government Revenues ($billions)

Year	Total Revenue	Property Tax		Other Taxes		User Fees & Utility		Miscellaneous		State & Fed. Aid	
		$	%	$	%	$	%	$	%	$	%
1940	7.7	4.2	54.5	0.3	3.9	1.2	15.6	0.1	1.3	1.9	24.7
1950	16.1	7.0	43.5	0.9	5.6	3.4	21.1	0.3	1.9	4.4	27.3
1960	37.3	15.8	42.4	2.3	6.2	8.4	22.5	0.7	1.9	10.1	27.1
1965	53.4	21.8	40.8	3.3	6.2	12.2	22.8	1.0	1.9	15.2	28.5
1970	89.1	33.0	37.0	5.9	6.6	19.2	21.5	1.6	1.8	29.5	33.1
1975	159.7	50.0	31.3	11.3	7.1	33.9	21.2	2.5	1.6	62.0	38.8
1976	178.3	54.9	30.8	12.7	7.1	38.2	21.4	2.8	1.6	69.7	39.1
1977	196.5	60.3	30.7	14.6	7.4	41.7	21.2	3.1	1.6	76.8	39.1
1978	214.5	64.0	29.8	16.3	7.6	46.6	21.7	3.4	1.6	84.0	39.2
1979	234.6	62.4	26.6	18.2	7.8	55.2	23.5	4.0	1.7	94.8	40.4

Source: Facts and Figures on Government Finance, 1981, Washington, D.C.: The Tax Foundation, Inc., 1981

have the imagination and courage to seek more efficient ways of providing public services?

ANOTHER ALTERNATIVE: PRIVATIZATION

The conventional approach to providing municipal services is for the local government to collect the revenues needed for the service and to deliver the service as well. The implicit premise in this view is that local public services are all "public goods"--i.e., goods or services that can only be produced and paid for collectively. Yet the fact is that most local public services (other than strictly wealth-transfer functions) have few attributes of true public goods. Most of them--including garbage collection, park and recreation services, libraries, airports, transit, and aspects of police and fire protection--have specific, identifiable users, who are the services' principal beneficiaries. To the extent that discrete user/beneficiaries can be identified, user fees become a viable alternative to taxation as a source of revenue. Moreover, even for services that are closer to being pure public goods, it is not at all clear that government must be the provider. Even where the revenue is best obtained via taxation, the service can be produced by (a) a private, for-profit firm, (b) a nonprofit organization, or (c) some other government jurisdiction that may be able to do the job more efficiently.

Shifting to an alternative means of public service delivery is often referred to as privatization.[1] Three variants of privatization are of particular significance in the case of municipal services, namely user fees, contracting out, and load shedding.

1) User fees

To the extent that a service is shifted from tax funding to user fees, the tax increase dilemma for revenue squeezed local governments is eased. Moreover, there is much economic evidence that services will be produced more efficiently and responsively when users provide direct feedback through utilization according to the price charged than when they provide only indirect feedback via the political process.

2) Contracting out

Contracting out refers to a variety of situations in which local government remains responsible for the funding of a service, but selects one or more providers by a process of competitive

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[1] See, for example, E.S. Savas, Privatizing the Public Sector (Chatham, N.J.: Chatham House, 1982); James T. Bennett and Manuel H. Johnson, Better Government at Half the Price (Ottawa, Ill: Caroline House, 1981); and Robert W. Poole, Jr., Cutting Back City Hall (New York: Universe Books, 1980).

bidding. There are several reasons why this alternative to traditional city provision usually leads to less costly, more responsive services. First, it is not likely that the area defined by a city's jurisdictional limits will coincide with the optimum area for most public services, since economies of scale vary dramatically among public services. A city that is the ideal size for the most efficient garbage collection system is probably far too small to provide a water or sewer system at the least cost to residents. Contracting for services permits selection of least cost producers without regard to jurisdictional boundaries.

Second, the need to compete for the contract changes the incentives facing the provider. In contrast to a conventional monopoly city agency, a private firm or a nonprofit agency which must compete with other providers for, say, a three-year garbage contract, has powerful incentives to rethink its use of personnel and equipment in order to deliver the required services in the most efficient manner.

c) Load shedding

This third form of privatization refers to a decision by local government to step back and allow the private sector to produce the service and offer it directly to consumers. Common examples are commercial and industrial (but usually not residential) refuse collection and personalized transit services (taxis). Both are usually left to the marketplace to provide on a voluntary basis, albeit usually with some degree of municipal regulation. Studies of privatization via load shedding suggest that additional current municipal services could be provided this way and that local governments' budget problems would be further eased.

EXAMPLES OF PRIVATIZATION

A close look at the variety of ways in which public services are delivered across the country reveals numerous examples of successful privatization. And where studies of cost effectiveness have been completed, the evidence strongly supports the theoretical case for significant cost savings.

Garbage Collection

Garbage collection is a service that provides examples of all three types of privatization.

Commercial and industrial refuse collection is largely a function of the private sector. In large central cities, it is still common for residential collection to be a function of a city sanitation department, and the service is generally provided without charge. But over the last five years a number of cities (e.g., El Paso and Fort Worth, Texas) have instituted specific fees to pay exclusively for garbage service.

The most important trend over the past decade has been the move toward contracting out residential collection. Nationwide studies in the United States, Canada, and Switzerland, as well as regional studies in Connecticut and the Midwest, have shown that government garbage collection is 29 to 37 percent more costly than private contract collection.[2] These comparisons actually underestimate the true disparity in the United States. A study by E. S. Savas found that municipal sanitation department budget practices understate the true cost of service by an average of 23 percent.[3] As these cost data have become better known, more and more cities have shifted some or all their residential garbage collection to a contract basis. Among those doing so in the past decade are Boston, Dallas, Gainesville (Florida), Jackson (Mississippi), Minneapolis, Oklahoma City, Omaha, St. Paul, and Utica (New York).

There are also a few examples of load shedding where cities decide to get out of the refuse collection business altogether. One such case is Wichita. Until 1978 that city's municipal sanitation department provided residential collection in part of the city, while the rest was served by private firms which contracted with individual homeowners. In the wake of a strike by city sanitation workers in 1978, however, the city decided to cease providing garbage services. Resisting pleas to divide the city into districts and franchise a single firm to operate in each on a monopoly basis, city officials instead stepped back and allowed the marketplace to function. Today there are dozens of companies in the Wichita market; in any given neighborhood, residents have a choice of several firms offering various combinations of price and service. The city's only responsibility is to ensure that each household makes some provision for disposing properly of its garbage.

Fire Services

Although most people do not realize it, fire protection also provides illustrations of all three types of privatization. In the wake of Proposition 13 in California, several cities passed legislation providing for a fire service fee to pay for a portion of the fire department's costs. In so doing they were supported by the analysis of such economists as Urban Institute researcher William Pollak, who concluded a decade ago that government provision of fire suppression services at no charge had led to an underinvest-

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2 E.S. Savas, "Public vs. Private Refuse Collection: A Critical Review of the Evidence," Journal of Urban Analysis, Vol. 6, 1979.

3 E.S. Savas, "Policy Analysis for Local Government: Public vs. Private Collection," Policy Analysis, Vol. 3, No. 1 (Winter 1977).

ment in fire prevention efforts by building owners.[4] A fire service fee, based on the extent to which a building places a demand on the fire suppression system, provides positive incentives to invest in alarm systems, sprinklers, and other preventive measures.

Inglewood, California, in 1978, was the first city to actually implement a fire service fee. The plan was for only "basic" fire protection to be funded from property taxes, with a business service financed by fees based on the calculated "fire blow" requirements of each commercial and industrial structure. The fee system was put into effect in the summer of 1978, but it proved politically unpopular, and it was suspended after the first year.

Faced with the fiscal stress of Proposition 2½, Boston officials introduced a fire service fee in July 1982. Like the Inglewood fee, it is applicable only to larger commercial and industrial buildings, and is expected to bring in some $8 million a year. But there is already talk of a court challenge by the real estate industry. Fire service fees obviously have a long way to go to gain general acceptance.

Equally controversial, but with a longer record of success, is the practice of contracting out fire service. The best-known example is Scottsdale, Arizona, a Phoenix suburb of 90,000 residents, which has been served by private fire services under contract since the city was incorporated in 1952. In 1976 a team of researchers from the California-based Institute for Local Self-Government made a detailed study of the cost and performance of the fire protection system in Scottsdale.[5] Comparing Scottsdale's fire service with that of nearby Glendale, Mesa, and Tempe (which have conventional government fire departments), they found that (1) response time was best in Scottsdale, even though it is the largest in land area, (2) the insurance rating of the fire departments is comparable--homeowners' rates, in particular, are the same in all four cities, (3) average annual fire loss is comparable in all the cities except Tempe (where it was nearly twice as high as in the other three). While the quality of fire protection differed little between Scottsdale and the other three cities, the per capita cost over the 1971-75 period averaged $6.48 in Scottsdale compared with $12.62 in Glendale, $11.43 in Mesa, and $10.68 in Tempe. In other words, by contracting out, Scottsdale was receiving comparable fire protection at only 56 percent of the cost in a city such as Mesa.

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4 William Pollak, "Pricing Fire Protection Services," in Selma Mushkin (ed.), Public Prices for Public Products (Washington, D.C.: The Urban Institute, 1972).

5 Alternatives To Traditional Public Safety Delivery Systems: Civilians in Public Safety Services (Berkeley, California: Institute for Local Self-Government, 1977).

Scottsdale is not an isolated example of private fire protection. It is part of a clear trend towards contracting out. The firm providing fire services in Scottsdale, Rural/Metro Fire Department, Inc., also contracts with several other Arizona cities. In 1977 the metro government in Nashville/Davidson County contracted with five small private fire companies to provide fire services in unincorporated areas. Two years later American Emergency Services Corporation won a contract to serve Elk Grove Township, Illinois, adjacent to Chicago's O'Hare Airport. At the same time, Hall County, Georgia, abolished its fire department and contracted out the service to Rural/Metro of Arizona. In January of 1982, the Hall County contract was won by Florida-based Wackenhutt Corporation, the nation's fourth largest private security firm. In addition, Wisconsin-based J.J. Security, Inc., has won fire and crash rescue contracts at the airports in Green Bay and Madison, Wisconsin, Oklahoma City, and Kansas City International Airport. There is even a trade association for private fire companies created in January 1982, the Private Sector Fire Association.

There are also some examples of load shedding in fire protection. In a number of unincorporated communities in Arizona, Georgia, Montana, Oregon, and Tennessee, fire services are provided on a subscription basis by private, profit-making companies. In some cases, these firms are the outgrowth of volunteer fire departments; as an area develops, citizens often demand a higher level of service than that which can be provided by a strictly volunteer organization. Because of the threat of fire spreading from house to house in high density urban areas, subscription fire service is not likely to be acceptable in most cities. But it appears to be a viable alternative for lower density suburbs and unincorporated areas.

Parks and Recreation

There seems to be no clear pattern for changing (or not) the system of park and recreation services. Some cities, such as Washington, D.C., make most of these services available with no user fees at all. At the other extreme are cities like Wheeling, West Virginia, and El Cerrito, and Newark, California, whose recreation programs are entirely supported by user fees.

The principal objection made against recreation program user fees is that they will deprive the poor. There are two important counterarguments. The first is that generally the poor are already paying for such programs--via property taxes (included in their rent payments), sales taxes, and excise taxes. Yet many municipal recreation facilities--tennis courts, golf courses, marinas, etc.--are used largely by middle and upper-income people. Although no definitive studies exist, it is likely that significant wealth transfers from the poor to the nonpoor are taking place in recreation programs funded by taxation, rather than by user charges.

The other counterargument is that the truly needy can always be exempted from the user fees. The Fairfax County, Virginia, recreation agency distributes sports complex passes to low-income children identified via the school lunch program. The San Juan School District in Sacramento, California, arranges for local businesses to give scholarships for low-income children to attend recreation facilities. And the Los Angeles County Art Museum provides free admission one day per month so that senior citizens and others with low incomes can avoid the (post-Proposition 13) entry fee.[6]

Contracting out is being used increasingly in park and recreation services. California has seen a great increase in the contracting out of park maintenance since Proposition 13. Most cities have dozens of commercial landscaping firms which are well-equipped to take over tree trimming, grass cutting, and other park maintenance chores. The savings typically are 30 percent or more; in Los Angeles County, some initial contracts have yielded 50 percent savings.

The operation of park and recreation facilities has also been contracted out. The contractors may be golf or tennis pros, commercial firms, or nonprofit organizations. In Rohnert Park, California, the city was plagued with a money-losing golf course that had become a considerable drain on the taxpayers. The city went out to bid and ended up with a thirty-year lease to a private firm, which is guaranteeing the city a minimum income of $60,000 a year, in addition to rebuilding the course.[7]

There are even some examples of load shedding in the leisure services area. Long-term leasing of large-scale facilities, such as golf courses, represents *de facto* load shedding. And the recent adopt-a-park trend on both the east and west coasts (including the San Francisco Bay Area and New York City) is a form of load shedding, whereby citizen groups and/or local businesses voluntarily agree to take over responsibility for maintaining specific parks.

Mass Transit

Nearly all municipal transit is operated on at least a partial user-fee basis. The problem is that the fares typically cover less than half of the cost of operation. The reason has to do with the changes in land-use patterns after World War II.

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6 Other examples of park and recreation user fees, and arguments for their use, can be found in *Fees and Charges Handbook* (Washington, D.C.: U.S. Department of the Interior, Heritage Conservation and Recreation Service, 1979).

7 Further examples and guidelines can be found in the *Contract Services Handbook* (Washington, D.C.: U.S. Department of the Interior, Heritage Conservation and Recreation Service, 1979).

In the 1950s most transit operations were private businesses. As people migrated to the suburbs, political pressures and bad business judgment caused the transit systems to spread out after them. But conventional bus systems found it difficult to stay profitable in low density areas, and bus systems began to go bankrupt. Nobel Prize winning economist F. A. Hayek speaks of the market as a giant information system. In this case, the market was telling us that the traditional form of busline was obsolete in the suburbs. But people and politicians refused to listen and cities took over the buslines in an effort to preserve the obsolete structure.

When that became increasingly difficult for cities, the federal response in the 1960s was to provide capital grants to enable cities to buy new buses. The theory was that new equipment would attract new riders and make the systems viable again. When that didn't work, the next major federal program, in the 1970s, provided large subsidies to help pay operating costs. Yet two-thirds of all the increased spending in the 1970s went directly into higher wages for bus drivers,[8] and transit unions resisted strenuously sensible measures to hold down costs--such as using part-time drivers at peak hours.

Simply raising user fees to full-cost levels would leave this inefficient transit system intact. Nor would contracting out make much of a difference, though there are transit management firms that can bring about some modest improvements in efficiency within the constraints of monopoly structure and price controls. Yet, given the cutback in federal operating subsidies, drastic changes are going to be necessary.

Economist James Ramsey has proposed load shedding as the solution for one especially beleaguered transit system--the New York City subways.[9] Pointing out that monopoly structure (and hence monopoly unionism and highly inefficient staffing practices) and price controls are primarily responsible for the system's deterioration, and citing the rising popularity of private express buses at three to four times the subway fare, Ramsey urges that the subway lines be auctioned off to the highest bidder, to be operated free of any government controls.

Other municipal transit monopolies could be treated in the same way. If that were done, the transit "system" that would emerge would be radically decentralized. If anti-jitney laws were repealed, and taxi pricing and entry restrictions decontrolled (as they have been in San Diego), low-density transit in a city

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8 Charles Lave, "Dealing with the Transit Deficit," Journal of Contemporary Studies, Vol. IV, No. 2 (Spring 1981).

9 James B. Ramsey, "Selling the Subways in New York: Wild-Eyed Radicalism or the Only Feasible Solution?" New York University, Department of Economics, January 1982.

could be provided cost effectively by hundreds (or thousands) of jitneys, minibuses, and shared rides in cabs. Such systems operate profitably in many cities in South America and Southeast Asia.[10] High-density commuter service would be provided by dozens of private express bus companies, of the kind that have sprung up in Southern California, New York City, and Chicago.

Infrastructure

It has become a cliché that the infrastructure--roads, bridges, water and sewer systems--in many cities is decaying. The pressure to "do something" about this has resulted various federal programs to bail out the cities--most recently, of course, the misnamed "repair" plan, to be funded by an increase in the gasoline tax. What most people fail to appreciate, however, is the institutional nature of the underlying problem.

For many years elected officials in the crumbling cities have been balancing budgets by putting off until the next administration needed expenditures on infrastructure maintenance. New York City's water and sewer systems should be being replaced on a 100-year cycle. Instead, they are being replaced on a 300-year cycle. New York's streets are on a 200-year cycle instead of the required twenty to twenty-five years. Needless to say, this cannot go on indefinitely. But politically, it is much easier for officials to heed the pleas of special interest groups for transfer payments and subsidies than to spend money on unglamorous projects like sewer maintenance. Furthermore, federal capital programs for new construction only add to the incentive to allow systems to run down to the point where they must be replaced with the help of Washington, rather than properly maintained by regular city expenditures.

Privatization provides an alternative answer to the infrastructure problem. If specific public works were placed on a self-supporting basis with user fees, the temptation of politicians to divert general fund money away from maintenance would be eliminated. The key to doing this is the creation of legal mechanisms, which separate the user fee revenue and earmark it exclusively for the system that generates it. In California this is frequently accomplished via separate "enterprise funds." In New York City, separate authorities--the Triborough Bridge and Tunnel Authority and the Port Authority of New York and New Jersey--were created for the same purpose. The bridges and tunnels run by the city are in very poor repair; those run by the separate authorities are kept in excellent shape.

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10 See Gabriel Roth and George G. Wynne, Learning from Abroad: Free Enterprise Urban Transportation (Washington, D.C.: Council for International Urban Liaison, 1982).

Although the President referred to it as a "user fee," the recently enacted federal gasoline tax increase is not a true user charge. For one thing, although it is collected from users of roads, one-fifth of the money is to be spent on mass transit systems. More fundamentally, the gasoline tax bears only a crude relationship to the relative share of the cost imposed on the road system by different types of users. In particular, heavy trucks pay only 60 percent of their fair share of highway costs, according to the Federal Highway Administration's cost allocation studies. In contrast, the tolls imposed by turnpike operators--a type of weight-distance charge--accurately reflect the relative costs of serving cars, buses, light trucks, and heavy trucks. Tolls are true user fees: the gasoline tax is not.

Proper user charges--for example, water and sewer bills or bridge tolls--can be the key to solving the infrastructure problem, as long as they can be legally earmarked to prevent diversion. But what about the roads? For over a decade economists have set forth the virtues of tolls on urban expressways. Not only would adequate funds for proper maintenance be assured, but the use of time-of-day pricing would provide economic incentives to reduce rush-hour congestion. In addition to political resistance, however, a principal drawback has been technological. Automated vehicle identification (AVI) systems, which would allow vehicles so equipped to bypass toll booths and be billed once a month, were simply not on the market. The good news is that such systems are nearing commercial feasibility.[11] The New York Port Authority is planning a large-scale test of several systems in the near future. Once such systems are in production, the practical barrier to user fees on urban expressways will be removed.

Contract operation of public works is also a viable option. A number of cities and special districts have had great difficulty operating modern sewage treatment plants in compliance with EPA requirements. At least two companies--Envirotech Systems, Inc. and Environmental Services, Inc.--have succeeded in winning contracts to operate such facilities for local governments.

There is even a role for load shedding in public works. Both Laredo, Texas, and St. Louis actively encourage residents to purchase neighborhood streets which carry little through traffic. A study by noted urban planner Oscar Newman found that privatized streets in St. Louis, many of them in poor neighborhoods, became islands of tranquility in the midst of chaos. Crime dropped substantially and investment in home repair and maintenance rose, because people who had formed a neighborhood association to

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[11] R.S. Taylor-Radford, "Rush-Hour Remedy," Reason, Vol. 13, No. 9 (January 1982).

purchase the street felt very protective about their block.[12]

In addition, serious suggestions have been made that bridges be privatized. A detailed cover story in Technology magazine gave examples of privately owned bridges (e.g. Ambassador Bridge linking Detroit and Windsor, Ontario) and pointed out the financial advantages that accrue to investors--sizable cash flows and huge depreciation write-offs.[13] Full-fledged privatization via load shedding may be the most feasible way of raising the billions of dollars needed to repair America's 200,000 deficient bridges.

IMPLEMENTING PRIVATIZATION

The foregoing discussion has made clear that privatization techniques make it possible to provide more public services for less money, especially less tax money. Why, then, aren't these techniques more widely used? The fact is that certain legal, tax, political, and psychological barriers to privatization must be addressed before the full benefits can be realized.

Legal constraints

Local officials do not always have the legal authority to privatize services. State laws vary in what they allow local government to do. In some states, for example, contracting out public safety services (e.g. police patrol) to private firms is not permitted. Other states impose no such restriction. In other cases, what is permissible for one form of local government (such as charter cities) may not be permissible for others (such as general law cities, special districts). Even the pricing of public services is frequently constrained by legislation. In some cases, charges of any kind may not be imposed; in other cases, shortsighted restrictions on the type of charges (e.g., prohibiting peak-load pricing) may exist.

What is needed at the state level is legal clarification of the right of all units of government to contract out, charge for, and/or simply supervise any and all public services. The federal government could assist by drafting model legislation for consideration by state legislatures. HUD's Division of Governmental Capacity Sharing should be the lead agency for researching and drafting such a model privatization law.

Tax Barriers

Another barrier to privatization--specifically to user charges and load shedding--is tax discrimination. State and local tax payments are deductible from citizens' federal income

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12 Oscar Newman, Community of Interest (New York: Doubleday, 1980).

13 Jeanne McDermott, "Bridges: Back to Private Enterprise?" Technology, Vol. 1, No. 2 (January-February 1982).

tax bills. But direct payments for public services, whether a user fee to local government or a fee paid directly to a private firm, are not deductible. Thus, taxpayers often object to proposals for privatizing services on the grounds that they will have to pay more in federal taxes.

A useful reform at the federal level, therefore, would be to enumerate the public services traditionally provided by local government--police, fire, recreation, parks, garbage collection, --and allow fees for these services, whether public or private, to be deductible from federally taxable income. This would put user-charge funded public services on an equal footing with tax supported, governmentally produced public services.

Another tax barrier exists at the local level. When citizens provide and pay for their own public services (e.g., a neighborhood association takes over responsibility for a street) rather than obtaining them from local government, they usually must continue to shoulder the same local tax burden as citizens who are not providing any of their own services. A sensible local reform would therefore be to provide tax credits against local property taxes for all expenditures by neighborhood or homeowners' associations which, by providing substitute public services, relieve the load on tax supported services. Once again, HUD could research and draft a model ordinance.

A precedent for this approach to privatization exists in Kansas City, Missouri, where, downtown, the garbage service is provided by a city department, and in the suburbs by private firms under contract with the city. In both cases, funding comes from local taxes. But Kansas City allows neighborhood associations and apartment buildings to opt out and hire their own garbage service, for which they receive a per-household rebate on property taxes from the city. As of 1978-1979, some forty-one homeowners' associations had opted out and were being served by twelve different garbage collection firms.

Federal Rules

A third barrier concerns local mass transit agencies. In order to implement the load shedding option, existing local transit agencies must be free to declare bankruptcy and sell off their assets to would-be private enterprise providers. Yet because nearly all of these systems' vehicles have been purchased with 80 percent funding from the Urban Mass Transit Administration, that federal money would have to be returned to UMTA upon dissolution of any of its grantees. Clearly, such a regulation is contrary to the public interest in solving severe transit problems of cities. A helpful reform at the federal level would be to rescind UMTA regulations requiring repayment of the grant funds, provided that the vehicles remained in service to the public under the new ownership following the dissolution of an existing mass transit agency.

Government and Union Obstruction

A fourth type of barrier is political and psychological: the resistance of city officials to privatization. In part, this simply reflects the generally status quo orientation of local politicians and bureaucrats. After all, for decades city department heads have been rewarded in proportion to the size of their departments, not how cost effectively they were operated. City officials are not used to thinking of themselves as facilitators of public service delivery rather than direct producers of the service. So they tend to resist privatization proposals and are skilled at coming up with numerous objections pointing out that while such measures may have worked elsewhere, their city is different.

Reinforcing this natural resistance is the organized opposition of public employee unions, which regard privatization as a threat to their continued growth and power. One such union has produced and widely distributed an extremely biased attack on contracting out services.[14] The unions' main arguments are that contracting out will result in large-scale layoffs of public employees and lead to political corruption in the selection of contractors. If privatization is to spread, the answers to these claims must be made available to local officials.

All of these factors suggest the need for developing and disseminating information on privatization to local officials. In England, the Adam Smith Institute has developed and implemented an extensive privatization information program, including a basic information packet for local officials, a technical manual, a newsletter, and a media campaign. The newsletter is currently being sent to some 18,000 persons, particularly to elected officials in cities considered to be ripe for privatization.

A similar effort would be very effective in this country. It would provide local officials with case studies in privatization, sample contracts, model bidding procedures designed to frustrate attempts at corruption, and perhaps directories of cities where privatized specific services and private firms are available as contractors. Private, nonprofit organizations such as the Reason Foundation's Local Government Center located in Santa Barbara, California, and the Sabre Foundation and the Taxpayers' Foundation (both of Washington, D.C.) have already developed some of the necessary materials.[15]

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[14] John D. Hanrahan, Government for Sale: Contracting-Out, the New Patronage (Washington, D.C.: American Federation of State, Country, and Municipal Employees, 1977).

[15] The Local Government Center is compiling a Directory of Private Service Providers and publishes a monthly privatization newsletter, "Fiscal Watchdog." The Sabre Foundation has produced a privatization oriented Sourcebook on Enterprise Zones. And the Taxpayers' Foundation published both a handbook, "Private Contracting," and a detailed technical manual on contracting, More for Less.

CONCLUSION

A fundamental change has taken place in the fiscal relationship between the federal government and localities. City officials must face up to the reality that outside aid will shrink, in real terms, over the next decade. Rather than simply accepting the dismal trade-off of either cutting back on public services or raising local taxes, cities would benefit far more by taking full advantage of the various forms of privatization. By contracting out public services, they can shift from high-cost monopoly producers to lower-cost producers who must compete for the business. By changing from taxes to user fees, they can relieve the burden on already strained local tax sources. And by selectively shedding the load of certain services altogether (garbage collection, transit, certain bridges, and streets), they can reduce their public service responsibilities to a more manageable size.

The federal government cannot force cities to make these changes. But it can facilitate the process, by providing the legal research necessary to draft model legislation and ordinances, and by collecting and disseminating information on how to make privatization work. Such modest efforts could make a large contribution to the ultimate success of privatization.

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The Heritage Foundation Backgrounder

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PUBLIC HOUSING: FROM TENANTS TO HOMEOWNERS

INTRODUCTION

Public housing projects in the United States have come to epitomize urban blight. While this view is exaggerated, it is nevertheless true that public housing represents one of the great ironies of federal intervention. When the program began in the 1930s, the assumption was that the projects would help ameliorate social problems in the cities by stabilizing communities and the housing stock. The reverse has been true.

Yet there is evidence, in this country and abroad, that certain inner city housing experiments can have positive results. They all have one thing in common--ownership. Whether the program is homesteading, where abandoned properties can be bought for a dollar, or the discounted sale of public housing to tenants (in Britain), the effect is the same. When residents acquire an equity stake in the future of their building, and hence their neighborhood, they gain incentives to change their behavior from destructive to constructive and to urge their neighbors to do likewise. And instead of economic improvement bringing with it the threat of increased land values and displacement, equity allows a resident to rise with the tide--not drown in it.

But, some would argue, the low income of public housing tenants precludes their becoming homeowners. The solution to this apparent barrier is to recognize that support for homeownership is entrenched in the tax codes. Thanks to the mortgage interest deduction, middle- and upper-income Americans have powerful tax incentives to become homeowners. This is no accident. The explicit purpose of the deduction is to help Americans purchase homes. Yet the low-income tenant, who pays little or no income tax, has no such incentive--so he must pay a far higher after-tax price than higher-income citizens buying exactly the same property.

Note: Nothing written here is to be construed as necessarily reflecting the views of The Heritage Foundation or as an attempt to aid or hinder the passage of any bill before Congress.

Congress and the Administration should recognize this inequity and establish a "Right to Buy" homeownership program in the inner cities, based on the sale of public housing buildings, at a substantial discount, to associations of occupying tenants. The Reagan Administration should establish an experimental program immediately using existing law. It should also seek legislation to permit tenant associations to apply directly to the Secretary of Housing and Urban Development (HUD) for permission to purchase buildings from their local Public Housing Authority (PHA). The legislation should also allow the Secretary to require the PHA to provide the tenant group with a mortgage.

Proponents of such a program would be blind if they overlooked its political advantages. A similar plan in Britain enabled Conservative Margaret Thatcher to make considerable inroads among traditionally Labor-voting public housing tenants in her landslide 1983 reelection. The New York Times noted after the election that:

> As political experts and party strategists sift through the results of Labor's crushing defeat...more and more are identifying the "homeowner mentality" of voters...as a crucial development.[1]

An inner city homeownership plan would extend the idea of owning a home to low-income Americans. It would help stabilize the value of public rental stock near tenant-owned units, and would plant the seeds of improvement in the nation's most desolate neighborhoods. It would be a logical companion to the enterprise zone approach to inner city development. Like the zone proposal, which seeks to unlock the entrepreneurial spirit, the Right to Buy program would draw on the strengths of residents to tackle the problems of their own community.

THE BRITISH RIGHT TO BUY PROGRAM

During the last five years, over 500,000 dwellings (out of a total public housing stock of approximately 7 million units) have been sold to public housing tenants in Britain under the "Right to Buy" scheme. Widening homeownership in this way is seen by the Thatcher government as central to its objective of reviving neighborhoods and encouraging self-improvement.

Stated simply, Britain's Right to Buy program allows public housing tenants to purchase their units at a discount on the market value of up to 60 percent, based on the length of tenancy.

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1 "In Housing Policy, It Seems the Tories Had a Winner," The New York Times, June 22, 1983.

1) Eligibility

A tenant obtains the right to buy if he or she has been a public housing tenant for at least two years[2] and the unit is the principal home. The tenant can purchase the unit jointly with up to three other family members, provided they have been living in the same unit for at least three months.

2) Discount

If the tenant has lived in public housing for three years, the unit can be bought at the market value less 33 percent. The discount increases by 1 percent for each additional year as a tenant, up to a maximum 60 percent discount after 30 years as a tenant.[3] The period counting toward the discount need not have been spent in the same unit, or even within the jurisdiction of the same housing authority. The valuation, upon which the discounted price is based, is calculated by the housing authority. If the tenant disagrees with that valuation, he can appeal to the District Valuer, an independent official whose decision is legally binding on both parties.

3) Finance

The purchaser has three options in raising the money to pay for the house.

a) The tenant can obtain a mortgage from a savings and loan association. Approximately half of all public housing sales are financed in this way.

b) The tenant has the legal right to a mortgage from the local housing authority. Basically the loan amount is limited to 2½ times the annual income of the purchaser, plus 1 times the annual income of any other family members assisting in the purchase. For purchasers over 60 years of age, the multiple is lower.

c) The tenant may buy the unit in stages. After buying at least 50 percent of the unit, with the usual discount according to length of tenancy, he can obtain full ownership by purchasing increments of 12½ percent. The tenant continues to pay rent on the portion still owned by the housing authority.

Like the purchaser of privately built housing, the public housing tenant-buyer can deduct mortgage interest payments from taxable income. The trouble has been that, if the low-income purchaser pays little or no income tax, the mortgage deduction is

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2 Decreased from three years in legislation passed in 1983.

3 Prior to the 1983 legislation, the maximum discount was 50 percent after 20 years.

practically worthless. Since April 1983, however, a low-income buyer in Britain has been able to utilize the Mortgage Interest Relief at Source Program. Under this, he can obtain a cash subsidy equal to the tax relief to which he is entitled (at the 30 percent lowest bracket), less the amount he can actually deduct from his tax bill--in effect a refundable mortgage deduction.

4) Value Recapture

A tenant-buyer cannot buy his unit one day with a 60 percent discount, sell it the next at the full market rate, and walk away with the difference. If the unit is sold within one year of the initial purchase, 100 percent of the discount must be repaid. This repayment requirement falls by 20 percent each year until, after five years, the unit can be resold without the repayment of any portion of the discount.

ANALYSIS OF THE BRITISH EXPERIENCE

The British program of public housing sales has been highly popular and had profound effects on many neighborhoods. As the program's proponents expected, signs of home improvement activity, close attention to maintenance, and resident involvement in neighborhood issues have become evident in communities where tenants are buying. The reason for this is simple, says Conservative Councilwoman Hazel Weiberg, "ownership gives them a greater stake in the community."[4]

Distribution of Housing and Sales

Approximately one-third of all housing in Britain is publicly owned rental accommodation. This is above the average for Western Europe, and far above the 1.5 percent in the U.S. In addition, the mean income of families in British public housing is not far below that of owner-occupying families, and it is a shade higher than families in private rental units. One reason for this is that local housing authorities cannot evict tenants whose incomes rise above the initial threshold for their unit. Moreover, the right of tenancy in a public housing unit in Britain can be passed on to an heir who has lived with the tenant. British public housing structures also differ from those found in American cities. While there are many examples of blighted high-rise properties, more typical is the well-built duplex or four-unit walk-up in a reasonably stable neighborhood.

The sales of British public housing reflect these characteristics. Data for 1982, for instance, indicate that the average

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[4] "New Law Transforms Britain Into a Nation of Homeowners," Wall Street Journal, September 14, 1983.

income of tenant purchasers was only 16 percent lower than that of all first-time house buyers in Britain, and 96 percent of public units sold were town houses, duplexes, or detached houses (only 4 percent were apartments). Nevertheless, sales were more common among lower-income public housing tenants than is usual for first time buyers. Forty-seven percent of public housing purchasers earned less than $10,000 a year (34 percent for all first-time buyers), and 14 percent earned less than $7,000 (9 percent generally).[5] Not surprisingly, in view of the discount based on length of tenancy, the average age of the tenant-buyer (43 years) was significantly above the average for first-time buyers (31).

Multi-Unit Buildings

The data indicate that the bulk of public housing sales in Britain have constituted purchases of fairly desirable types of housing to tenants who would not be classified as very poor. So American policymakers should not assume that the typical Right to Buy sale involves a welfare mother buying her high-rise apartment.

Indeed, it is the high-rise apartment that has been the most difficult for local authorities to sell to tenants. British officials are quick to point out, however, that a high proportion of Britain's multifamily urban public housing was built after the Second World War with poor material and designs. Inadequate durability and structural problems make these units very unattractive for purchase, even at low prices. Would-be buyers in such buildings are inclined to remain on the waiting list for a more desirable property (using the waiting time toward a larger discount).

A second key factor is the unfamiliarity of the British with mechanisms such as tenant management or cooperative ownership. Tenant management is almost unknown in Britain, and cooperative ownership is rare. Consequently, say British officials, tenants have a strong resistance to the only forms of purchase and organization that are practical for low-income people in multifamily buildings. Even when a tenant buys his home in a 4-unit walk-up, the local authority usually retains the responsibility for the common areas and general maintenance (with a service fee), rather than have the owners accept this responsibility.

Lessons of the British Model

Despite such differences between the U.K. and U.S. situations, the British program contains important lessons for a workable approach on this side of the Atlantic.

The first is that a discount based on length of tenancy is a powerful stimulus and a means of favoring the most stable tenants.

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5 Assuming one pound = $1.40.

Initial fears that the discounts would provoke anger among working class buyers of private homes (who enjoy no such discount) proved groundless. The discount strategy has enabled many long established tenants to become even firmer anchors in the community.

A second lesson is that the resale value recapture mechanism is an important ingredient of the British program. It discourages rapid resale--which would undermine the otherwise stabilizing features of the program. On the other hand, the prospect of capital gain is important to a purchaser. In neighborhoods where market prices are not rising, or even falling, the sliding scale recapture provision in Britain allows for a potential capital gain within a reasonably short time.

The third lesson is that an American version of the British plan would have to overcome the problem of selling apartments to low-income tenants. Given the familiarity of Americans with cooperative ownership, this should present fewer problems than it has in Britain. Nevertheless, the high concentration of low-income people in American public housing would require more creative financing arrangements than are typical in Britain.

A PROGRAM FOR THE UNITED STATES

Since 1949, Congress has targeted the public housing program increasingly toward lower-income and welfare families, rather than those with modest incomes. Unlike Britain, therefore, the family income of a typical American public housing tenant is well below the national median--posing problems for any sales policy. Legislation does give a Public Housing Authority (PHA) in the United States the power to sell a "low income project to its lower income tenants." The sale price is usually based on the portion of the original development cost still outstanding--not the current market value. So discounted sales are permissible in the U.S.

This and other legislation have led to a number of home ownership programs for low-income tenants. The Turnkey III program, begun in 1968 and terminated in 1973, used the PHA framework to develop housing projects for sale, on a lease-purchase basis, to groups of public housing tenants with sufficient incomes to permit a sale without continued operating subsidies. The price was based on the total original development costs, and if the buyer were to resell the unit within five years of receiving full title, the PHA was entitled to recapture the capital gain according to a sliding scale. A requirement for success was the ability of the buyer to undertake basic maintenance and to accept the financial and other obligations of ownership.

Similar problems arose with the Section 235 Homeownership Program, another major federal initiative to encourage low-income homeownership through the sale of new or extensively rehabilitated units. The income problem was compounded in the case of Section

235 by the low (3 percent) down payment requirement--which could be in the form of "sweat equity" (that is, provided in the form of on-site work rather than cash). This meant that the loan-to-value ratio could easily come to exceed 100 percent in an unstable neighborhood--encouraging others to abandon their properties at the first need for substantial maintenance outlays.

The most extensive and perhaps most interesting low-income ownership program, however, has been the Indian Mutual Help Ownership Opportunity Program, which constitutes 61 percent of HUD assistance in Indian areas. Families or tribes must make a down payment contribution of at least $1,500 toward each unit, in the form of cash, land, or work. The resident can acquire title to the unit, generally after 25 years, through a lease-purchase plan that allows equity to be built up gradually. The program has been very popular and effective, covering over 30,000 units.

Mutual housing associations (MHAs), as a homeownership vehicle for public housing tenants, have attracted considerable attention in recent years. Proposals are now being formulated in Patterson, New Jersey, for example, which would use the model to transfer 242 public housing units into tenant ownership. The title of the building first would be transfered to a mutual housing association made up of residents. This MHA would be affiliated to a city-wide MHA with a board of directors drawn from city officials and local organizations. This city-wide MHA could enlist support and provide technical assistance for would-be buyers, thereby improving the chances of successful ownership by individuals, who would be able to purchase title from the MHA.

THE PRINCIPLES OF A NEW OWNERSHIP INITIATIVE

Drawing on British and American experience in encouraging ownership among low-income tenants, principles for a successful homeownership program for public housing tenants emerge. Among them:

1) Discounts and Equity

It is clear from the problems associated with Section 235, and in contrast, the success of the British approach, that buyers must feel they have sufficient stake in their homes to justify expenditures on maintenance. Discounting the price (giving the prospect of a substantial capital gain) would provide that stake indirectly but effectively: a token down payment does not.

Current law permits HUD to sell to a resident tenant at a discount with the federal government paying off part or all of the existing capital debt. Similarly, units can be modernized without the tenant-buyer being required to pay the cost of modernization.

2) A Subsidy to Buyers

Some critics of discounted sales to low-income buyers charge that this constitutes an unfair valuable subsidy to the buyer. These critics overlook the mortgage deduction available to middle- and upper-income buyers--which is of little value to low income buyers. If the purpose of Treasury assistance is to help home-buyers, then a price discount on public housing would be a rational and equitable device to help low-income buyers. Depending on the discount chosen and the tax savings (if any) usable by purchase, a case could also be made--again on equity grounds--for some interest relief for low-income buyers. It would be reasonable for the interest payable on PHA-provided mortgages to be reduced by an amount at least equal to the lowest marginal federal tax rate.

3) Netting for Other Subsidies

Subsidy calculations should also be adjusted for the subsidies to other groups already included in the cost of public housing. American Enterprise Institute scholar John Weicher notes that studies suggest that new public housing units cost about 25 percent more than comparable private housing. The major reasons for this are the high tax revenue costs associated with tax-exempt financing often used in such projects (a subsidy to higher-income investors) and high construction costs due to the application of the Davis-Bacon Act (a subsidy to construction workers).[6] There seems little justice in forcing low-income homebuyers to cover the capital cost of a subsidy to Americans earning well above their income. The cash basis for any calculation of purchase price, therefore, should net out such subsidies.

4) Developing Homeowner Attitudes

A major problem associated with low-income buyers, even if financing can be arranged, is that they often lack the maintenance and accounting skills needed for homeownership. On the other hand, some remarkable successes have been achieved with tenant management associations as vehicles to encourage sound maintenance techniques--especially when cash incentives were utilized. As head of Newark's public housing in the 1970s, for instance, Tom Massaro sought to cut costs by inviting tenants to take over many responsibilities. For every dollar this saved the city, the tenants were allowed a portion to finance community activities. The result: vandalism and utility costs plummeted and tenants acquired useful maintenance skills.

Another tenant management association in Kenilworth Courts, Washington, D.C., has achieved dramatic cost reductions by training

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[6] John C. Weicher, Housing (Washington, D.C.: American Enterprise Institute, 1980), p. 59.

its own tenants in management and maintenance skills. A preliminary study by the American Enterprise Institute's Neighborhood Revitalization Project found that within one year of the 1982 turnover to tenant management, administrative costs were cut by 63 percent, and maintenance (the major outlay) by 26 percent. In addition, rental income was increased significantly, thanks to improved collection and reduced vacancy rates, such that the project began to run a healthy operating surplus.

Success as a tenant management asssociation could be a sensible prerequisite to apply to a group of public housing tenants wishing to purchase as a cooperative. An alternative requirement would be the creation of a private Mutual Housing Association, as that suggested in Patterson, New Jersey, to provide management assistance and training to achieve operating cost reductions. The tenants would be members of this association, which could foster cooperative or any other suitable form of tenant ownership. Another equity-building approach would be for the tenants to enter into a lease-purchase agreement. The operating subsidy would then be capped, and savings achieved by the tenants would be accumulated as equity shares until the full purchase could be accomplished, whereupon title would be transferred.

The savings achievable through tenant management is critical both to the success of any ownership plan and to the number of tenants that could hope to utilize it. Most studies of the potential for ownership among public housing tenants suggest that it is very small. But these calculations ignore the substantial reductions in cost that can be achieved--if tenants have an incentive--and thus grossly underestimate the possibilities of ownership.

A PUBLIC HOUSING HOMEOWNERSHIP PROGRAM

The Administration, utilizing existing law and with the agreement and cooperation of communities and PHAs, should experiment with a homeowner program for public housing tenants. The President should make it clear that the objective is not to raise income but to promote ownership in poor communities. Special buildings for the elderly or the handicapped should be excluded from the program, so that the number of such units available for rent would not be reduced.

In addition, Congress should enact a "Public Tenants Right to Buy Program." The measure should give groups of tenants the right to be included in the homeownership program, even if the local PHA opposes ownership. Such a group of tenants would apply directly to the Secretary of HUD. If eligible, according to the criteria below, HUD would set in motion the ownership process, and the PHA would be required to provide the resident association with a mortgage according to HUD rules. Legislation should also be enacted to expand the housing voucher program so that tenants

unable to buy a share of a co-op, or other ownership vehicle, such as lease-purchase, could continue as renters.

Eligibility

The program would center generally on purchases by successful tenant management associations. As the tenant management associations or mutual housing associations improved tenant skills and reduced operating costs, savings to the PHA would be placed into an escrow account toward the purchase price, or as the equity element of a lease-purchase agreement. The purchase process would begin when this transitional arrangement reduced running costs sufficiently for the tenants to have a reasonable chance of meeting the costs of ownership.

To be eligible for membership in the purchasing organizations, tenant-buyers should have been good tenants in the specific building for at least one year and good public housing tenants for at least three years. This would help assure stable buyers of good character. Tenants unable to meet this criterion would not be permitted to purchase.

Discount and Resale

An eligible association, comprised of eligible tenants, would be allowed to purchase the building at 30 percent of the assessed market value. No down payment would be required. If a co-op member were to sell his share within the one year, his portion of the entire 70 percent discount would be repayable to the PHA. This repayable portion would fall by 10 percent annual segments (of the initial market price) until, after seven years, the member would be free to keep all resale proceeds. The prospect of gain should be sufficient to establish the notion of equity, and so offset the lack of a down payment.

Financing

Eligible tenant management associations accepted into the program would have the right to a mortgage from the PHA under the legislation proposed. Since the PHA would be the owner of the building in the first place, this would involve no transfer of cash, only the replacement of rent payments to the PHA with mortgage payments. The interest rate on the mortgage would be adjusted to reflect the marginal tax benefits available to typical first-time homebuyers.

Tenant associations could purchase outright or purchase according to a shared-equity plan. With either method of purchase, the housing authority would continue to operate the units occupied by tenants refusing or ineligible to join the ownership associations. Existing tenants, in other words, would not be evicted. Eligible tenants could, however, buy into the purchase plan at any time. If some of the tenants continued to remain renters, supported by the government, that portion of the building would

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be considered a set of units owned by the PHA--thus the PHA would not be a shareholder in the cooperative. However, maintenance services to these units could be provided by the tenant ownership association under contract. An alternative might be for the federal government to guarantee to the association owning the building that vouchers would be provided to meet the costs of units still occupied by tenants.

Under a shared-equity arrangement, the tenant association could, in effect, buy a portion of the unit (minimum 50 percent) and continue to pay rent to the PHA on the remainder. The association could add to its ownership in increments, as finances permitted. Payment could be made in-kind (such as maintenance work) to obtain additional ownership shares. An alternative approach would be a lease-purchase arrangement, where tenants could build up equity credits, but would not take title until they could finance the entire sale price of the building.

Resale

The part-owner could sell his unit in the normal way, subject to the provisions regarding discount repayment, but he would have to return the original cost of the rented portion of his unit to the PHA. Alternatively, he could sell his share to an eligible buyer willing to take on his shared equity responsibilities. The tenant would have the right to a mortgage from the PHA, with a limit based on income and a below-market interest rate, offsetting the reduced tax relief available to low-income tenants.

CONCLUSION

The program suggested is not a proposal to sell off public housing to developers or suburban homesteaders. It is a device to provide ownership opportunities for existing tenants of public housing projects. If successful, it could transform some of the most troublesome communities in the nation's urban areas. It draws on the known successes of tenant management associations and that powerful ingredient of commitment to neighborhood--ownership. Turning public housing tenants into homeowners in this way would utilize the strengths and ownership dreams of residents themselves to help overcome the debilitating problem of America's inner cities.

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PRIVATIZATION IN THE U.S.:

CITIES AND COUNTIES

NCPA POLICY REPORT 116

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EXECUTIVE SUMMARY

A privatization revolution is taking place among cities and counties throughout the country. Privatization--the practice of transferring assets and activities out of the public sector and into the private sector--is an option local governments are increasingly turning to in order to cut costs and avoid tax increases.

- About 35 percent of local governments now contract with private companies for residential garbage collection.
- About 44 percent of local governments contract for commercial garbage collection.
- About 80 percent contract out vehicle towing and storage.

Private, for-profit firms also are under contract with city governments to repair streets, to control traffic, to provide ambulance service, to fight fires, to provide crime control, to manage public works, to manage cemetaries, museums, parks, tennis courts, swimming pools and arts and cultural centers and even to manage entire city governments.

Over the last decade there has been a virtual explosion in the extent of privatization by local governments.

- Between 1973 and 1982, the use of private firms to manage parks has increased by 2,700 percent.
- For managing recreational facilities there has been a 1,600 percent increase; for data processing a 3,600 percent increase.

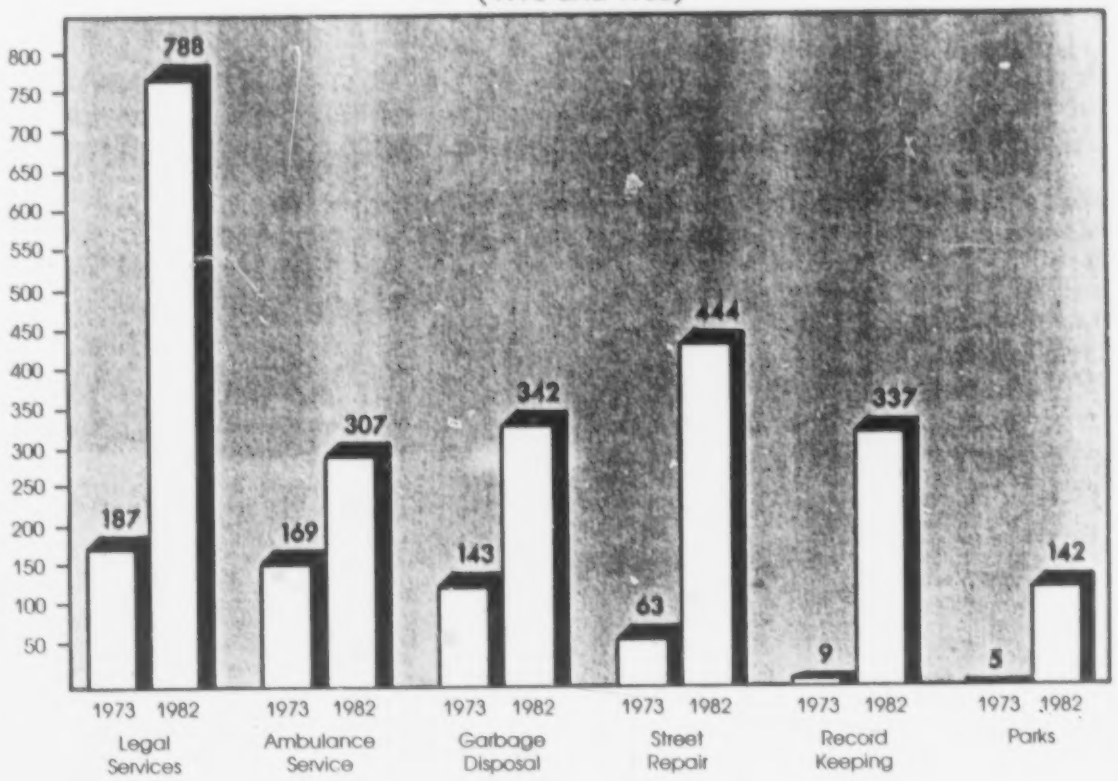
The reason for privatization is almost always the same: to save money. When cities rather than private firms provide city services, street cleaning costs about 43 percent more, garbage collection costs about 42 percent more, janitorial services cost about 73 percent more, and asphalt-overlay costs about 100 percent more.

Most city governments are not well-managed, and in most cases local governments pay far more than they have to for basic city services. A California study showed that:

- Some cities spend seven times as much as other cities for janitorial services.
- For traffic signal maintenance, asphalt overlay, grass maintenance, payroll preparation, garbage collection, street sweeping, and street tree maintenance, the variation in cost among cities ranges from 350 to 650 percent.

Such variations in cost are literally unheard of in the private, for-profit sector of the economy. On the average, city governments can cut in half the cost of city services by contracting with private firms.

GROWTH OF PRIVATIZATION
Cities And Counties Contracting With
Profit-Making Firms
(1973 and 1982)



PRIVATIZATION:

A WORLD-WIDE REVOLUTION[1]

The explosive growth of government is a world-wide phenomenon. So are the problems that accompany it. Nations around the globe are experiencing more and more demands on their treasuries and a limited supply of tax revenues to pay these services. Increasingly, countries are turning to privatization as a way of dealing with budget problems.

Privatization means the transfer of government activities and assets to the private sector. It can be accomplished by selling an activity, by leasing it to the private sector, or even by giving it away. Britain began a major program of privatizing numerous state-owned industries in 1979, under the new leadership of Margaret Thatcher. Other countries, including the European nations of Belgium, West Germany and France, are experimenting with the idea. Japan, Malaysia and Singapore have major privatization projects under way. There have even been privatization experiments in the People's Republic of China.

PRIVATIZATION IN THE U.S.

The most extensive use of privatization techniques in the U.S. is occurring among U.S. cities. Increasingly, municipal governments are beginning to contract with private companies to provide city services--everything from landscaping and vehicle maintenance to dog-catching and garbage collection. Why

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[1]Among the earliest works pointing out the potential benefits of privatization to city governments are Robert W. Poole, Cutting Back City Hall (New York: Universe Books, 1980); James T. Bennett and Manuel Johnson, Better Government at Half the Price (Ottawa, Illinois: Caroline House Publishers, 1981) and E.S. Savas, Privatizing the Pubic Sector (Chatham, New Jersey: Chatham Publishing House, 1982). A data bank on local privatization in the U.S. is maintained by the Local Government Center, Reason Foundation, Santa Barbara, California. The first book to explore the political theory behind privatization and examine successful techniques for achieving privatization through the political process is Madsen Pirie, Dismantling the State: The Theory and Practice of Privatization (Dallas, Texas: National Center for Policy Analysis, 1985). The proceedings of a conference designed to explore ways of implementing these techniques in the U.S. is contained in John Goodman, editor, Privatization (Dallas, Texas: National Center for Policy Analysis, 1985), forthcoming.

are cities turning to privatization? Privatization is often politically practical because it doesn't eliminate services; it transfers them to the private sector. And, it has proven to be an effective tool for reducing government expenditures.

City administrators for years have been using private contractors on an ad hoc basis. Now government contracting with private companies is becoming a regular approach. In cities across the U.S., officials who once thought of privatization as a possible alternative are now considering it a necessity. Consider the extent to which cities now contract with private, profit-making firms:[2]

- 35 percent of local governments contract out residential garbage collection; 44 percent contract out commercial garbage collection.
- 42 percent contract out the operation and maintenance of their bus systems.
- 80 percent contract out vehicle towing and storage.
- 35 percent contract out the operation of day-care facilities.
- 30 percent contract out the operation and management of hospitals.

Private, profit-making firms are now under contract with cities to manage cemetaries, museums, parks, tennis courts, swimming pools, and arts and cultural centers. Profit-making firms also are under contract to repair streets, control traffic, provide ambulance service, fight fires, provide crime patrol, manage public works, and even to manage entire city governments.

Table I provides a partial list of services now being provided to cities and countries by profit-making firms. What is most striking about the table is the length and diversity of services. Indeed, there is hardly a single city service that is not being contracted out to a private firm somewhere in the U.S.

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[2]Carl F. Valente and Lydia D. Manchester of Management Information Service, Rethinking Local Services: Examining Alternative Delivery Approaches (Washington, D.C.: International City Management Association, 1984) p. XV.

The major reason why cities are privatizing their services is an economic one: to reduce the strain on tight budgets at a time when voters are resisting higher taxes. City governments that are awash with cash rarely privatize anything. Two developments have spurred the trend: (1) growing demands on city budgets from interest groups which are becoming increasingly better organized and more skillful at exerting political pressure in pursuit of their interests, and (2) a cutback in subsidies by the federal government. As Washington scales back on aid provided to local governments, there is more pressure on city managers to find efficient ways of delivering city services.

The use of private firms to deliver goods and services previously provided by government has grown steadily in recent years. More cities are contracting out for the first time, and cities which already have tried privatization are increasing the number of privately delivered programs.

Table II shows the amazing growth in privatization between 1973 and 1982. In virtually every category of city service privatization is on the upswing. In many cases, the growth rate in privatization has been explosive.

- Over the last decade, the use of private firms to manage parks has increased 2,700 percent.

- For managing recreational facilities there has been a 1,600 percent increase; for data processing a 3,600 percent increase.

It is worth noting that the numbers in Table II probably understate the growth of privatization, because fewer cities and counties were sampled in the 1982 survey than in the 1973 survey.

How far can privatization go?

- La Mirada, California (population 40,000), contracts out more than 60 city services, and has only 55 employees.

- The Trophy Club, a recently incorporated suburb of Dallas, has only one paid city employee--a secretary.

Yet by and large, most U.S. cities have not taken full advantage of the opportunities which privatization offers. As Table III shows, among major U.S. cities typically less than half of city services are delivered privately, and less than half of those are delivered by for-profit firms. Even when cities rely on private delivery, about half of the time privatization is only partial, with the city continuing to provide some of the service with city employees.

TABLE 1

EXTENT OF PRIVATIZATION

Number of Cities and Countries Contracting With Profit-Making Firms, 1982

SERVICE	NUMBER
Public Works and Transportation	
Residential solid waste collection	482
Commercial solid waste collection	487
Solid waste disposal	342
Street repair	444
Street/parking-lot cleaning	133
Snow-blowing/sanding	180
Traffic signal installation/maintenance	408
Meter maintenance/collection	45
Tree trimming/planting	450
Cemetery administration/maintenance	77
Building inspection/code enforcement	111
Parking lot/garage operation	94
Bus system operation/maintenance	122
Paratransit system operation/maintenance	129
Airport operation	127
Utility meter-reading	120
Utility billing	162
Street light/operation	501
Public Safety	
Crime prevention/patrol	50

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Police and fire communications	17
Fire fighting/prevention	15
Emergency medical service	187
Ambulance service	304
Traffic control/parking enforcement	15
Vehicle towing/storage	1,028
Health and Human Services	
Sanitary inspection	9
Insect/rodent control	145
Animal control	89
Animal shelter operation	159
Day-care facility operation	153
Child welfare programs	28
Programs for the elderly	48
Operation/management of public housing for elderly	78
Operation/management of hospitals	108
Public health programs	58
Drug-alcohol treatment/programs	38
Mental Health/retardation programs/facilities	36
Parks and Recreation	
Recreation services	58
Operation/maintenance of recreation facilities	123
Parks landscaping/maintenance	162
Operation of convention center/auditorium	22
Operation of cultural arts programs	49

Operation of libraries	12
Operation of museums	20
Support Functions	
Buildings/ground maintenance	334
Building security	120
Fleet management/vehicle maintenance	526
Heavy equipment/emergency vehicles	483
All other vehicles	473
Data processing	337
Legal services	788
Payroll	172
Tax billing processing	137
Tax assessing	73
Delinquent tax collection	121
Secretarial services	66
Personnel services	83
Labor relations	348
Public relations/information	108

SOURCE: Carl Valente and Lydia Manchester, Rethinking Local Services: Examining Alternative Delivery Services (Washington, D.C.: International City Management Association, 1984), Table B, p. XV.

TABLE II

GROWTH OF PRIVATIZATION:

CITIES AND COUNTIES CONTRACTING WITH PROFIT-MAKING FIRMS

1973 AND 1982

SERVICE	1973[a]	1982[b]
Ambulance Service	169	303
Solid Waste Disposal	143	342
Refuse Collection	339	486
Hospitals	57	108
Street Repair	63	444
Utility Billing	104	161
Cemeteries	47	77
Data Processing (records maintenance)	9	337
Payroll	65	172
Legal Services	187	788
Public Relations	30	108
Recreational Facilities	7	123
Parks	5	142
Fire	2	15
Crime Patrol	2	50
Traffic Control	5	15
Museums	12	20
Number of Cities and Counties Sampled	2,375	1,780

NOTE: Columns are not exactly comparable because of differences in the sample base and, in some cases, differences in the definition of the service.

(a) Derived from Advisory Commission on Intergovernmental Relations, The Challenge of Local Government Reorganization, Vol. 3, (Washington, D. C.: U.S. Government Printing Office, 1974) Appendix Table 3.A. Reprinted in E.S. Savas, Privatizing the Public Sector (Chatham House, 1982), Table 4.2, pp. 63-64.

(b) Derived from Carl Valente and Lydia Manchester, Rethinking Local Services: Examining Alternative Delivery Services (Washington, D.C.: International City Management Association, 1984), Table B, p. XV.

TABLE III

PRIVATIZATION IN SELECTED CITIES

City	Number of Services Provided by For-Profit Firms	Number of Services Provided by Private Delivery: All Types*
Atlanta	10	24
Dallas	7	17
Detroit	6	14
Philadelphia	16	27
Phoenix	24	32
Pittsburgh	10	19

* In about 50 percent of these cases the service is partly provided by the local government and partly provided by an alternative means.

SOURCE: Local Government Center, Reason Foundation; Santa Barbara, California.

SEVEN METHODS OF PRIVATIZATION

There are seven major methods that cities and towns have used to privatize the delivery of services:

1. CONTRACTING

This is the most widely used approach. It most frequently is used for public works and transportation, health and human services, city support functions and some public safety services.

An important feature of contracting is that of all the seven privatization methods, it holds the most potential to reduce costs. The competition between firms bidding for a service contract drives the cost down. Another potential benefit of contracting is that it allows a local government to temporarily increase services, for example on a seasonal basis, without having to hire permanent employees. It also allows a government to use workers with highly specialized skills that may be unobtainable through its own civil service.

It is worth noting that a contract can have a negative price, i.e. a private producer can pay the government for the privilege of performing the service. In New York City abandoned cars are picked up by private firms who pay the city for the right to perform the service.[3] The collection of waste-paper or other recyclable materials are other examples.

Many cities and counties contract with nonprofit organizations for certain services. According to a recent survey, at least 20 percent of local governments contract with nonprofit organizations for services such as operating day-care facilities, child welfare programs, programs for the elderly, hospital management, museums and other cultural programs.[4]

2. FRANCHISES

Under a franchise arrangement a government grants a private provider the authority to deliver a service within a geographic area. Users of the service pay the provider, not the government. However, the government can regulate the level of service, its quality, and sometimes its price.

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[3]E.S. Savas, Privatizing the Public Sector (Chatham, New Jersey: Chatham House Publishers, Inc., 1982), p. 65-66.

[4]Rethinking Local Services, p. XV.

Franchises are most frequently used for garbage collection and disposal, bus and airport operation, utility billing and meter reading, street light operation, vehicle towing and storage, ambulance service and emergency medical service. The primary benefit of franchising is that it allows a government to completely turn a service over to a private firm, while still allowing it to set service standards and rate structures. Because users of the service pay the provider directly, franchise arrangements work best when there is competition among providers and when consumers can freely change providers.

3. SUBSIDIES

Many cities find that subsidizing a service provided by a private entity is a lot cheaper than when the service is provided by the city itself.[5]

- Garden Grove, California, saved about $72,000-a-year by turning its cultural arts center over to a nonprofit group, to which some subsidy is given.

- The city also cut the cost of its youth counseling program in half by turning it over to a nonprofit organization.

4. VOUCHERS

Under a voucher system, consumers are issued a coupon with a monetary value that can be used to purchase a particular good or service. The food stamp program is a voucher system. Although used infrequently, vouchers have the potential for a widespread application.

A principal advantage is that consumers can shop with their voucher in the marketplace and take advantage of the benefits of competition.

- In Hennepin County, Minnesota, low-income residents can use city-funded vouchers at any licensed day-care center.[6]

- In Kinston, North Carolina, elderly and handicapped people can use vouchers to pay for cab fares.[7]

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[5] Rethinking Local Services, pp. 224-226 and pp. 227-230.

[6] Rethinking Local Services, pp. 231-235.

[7] Rethinking Local Services, pp. 236-239.

- Vermont has had an educational voucher system for decades.[8]

5. VOLUNTEERS

As local governments face increasing pressures on their budgets, many city managers may be surprised to learn that there is a large pool of intelligent, able-bodied workers willing to work for free. Volunteerism is not a relic of the past. Nor is it confined to small cities. Many large cities are finding the volunteer efforts of teenagers, housewives and senior citizens can be used to save a lot of money.

- In Baltimore, deputized volunteers are used to enforce sanitation and building codes.[9]

- In New Orleans 3,000 volunteers are used city-wide in 85 different agencies.[10]

Virginia Beach, Virginia, (pop. 263,000) seems to have taken the lead in showing how far volunteerism can go:[11]

- The Virginia Beach libraries use more than 100 volunteers, saving the city about $42,000 annually.

- Virginia Beach recreational programs are run with the help of about 3,000 volunteers.

- The Virginia Beach police department uses more than 60 volunteers in its non-uniformed divisions, and can draw on up to 90 additional volunteers trained to serve as uniformed officers.

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[8]John McClaughry, "Who Says Vouchers Wouldn't Work?," Reason, January, 1984, pp. 24-32.

[9]Rethinking Local Services, pp. 249-251.

[10]Rethinking Local Services, pp. 252-255.

[11]Rethinking Local Services, pp. 256-259, 260-262, and 266-270.

6. SELF-HELP

Self-help is a variation of volunteerism whereby workers are the beneficiaries of their own efforts. Neighborhood watch groups are an example. Other programs often having at least an element of self-help include programs for the elderly, recreation services and cultural programs.

REGULATORY AND TAX INCENTIVES

These techniques are used by local governments to encourage the private sector to provide public services, thereby reducing demand on public revenues. This strategy involves reducing regulatory barriers to business, and reducing taxes or establishing new tax incentives for the private sector to deliver a public service. Although a frequent tool of the federal government, it is used infrequently at the local level. Applications include residential garbage collection, bus system operation, ambulance service and insect and rodent control.

PRIVATIZATION THROUGH THE MARKET[12]

There is an eighth way of encouraging private sector provision of goods and services. It often is an unintended consequence of government policy rather than the result of deliberate design. If government refuses to provide public schools, private schools will soon flourish. If government refuses to carry the mail, private mail carriers will do so. If government refuses to provide police protection, private protection companies will develop. We tend to forget that throughout the 19th century, government was usually a latecomer in providing most public services--entering the market only after private entreprenuers had demonstrated that a demand for the service was there.

Today, market provision of public services is most common in areas where government provision becomes notoriously inadequate. Take police protection, for example. Since 1960, the number of serious crimes in the U.S. quadrupled, rising from 3.3 million crimes in 1960 to 13 million in 1982. The public response to a rapidly rising crime rate has been predictable. People have sought to purchase privately the protection and security that is not being provided publicly.

- In 1960, the number of publicly employed policemen outnumbered private security guards. Today there are twice as many private security guards as there are policemen.

- Households and businesses now are spending about $15 billion per year on private police protection--about the same amount that we spend on public police protection.

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[12]The statistics in this section are taken from Morgan Reynolds, Crime by Choice (Dallas, Texas: Fisher Institute, 1985) and conversations with the author.

HOW INEFFICIENT ARE CITY GOVERNMENTS ?

Before examining the potential benefits of privatization, we can profit by taking a look at what city governments are doing right now.

Economist Barbara Stevens recently made an exhaustive study of eight major city services in 121 cities, in the Los Angeles Standard Consolidated Statistical Area.[13] One of the most interesting findings was that there exists huge variations in the cost of providing services among the cities--variations on an order that are virtually inconceivable in the private, profit-making sector of the economy.

For example, Stevens found:

- The cost of janitorial services in some cities is more than 700 percent greater than in other cities.

- The cost of street tree maintenance in some cities is almost 650 percent greater than in other cities.

- For traffic signal maintenance, asphalt overlay, turf maintenance, payroll preparation, refuse collection and street sweeping, the variations in cost range from 350 percent to almost 600 percent.

A natural question to ask is whether these differences in the cost of city services reflect differences in the quality of the services. As it turns out, Stevens found large differences ranging from "extremely high" quality to "extremely low." Yet these differences in quality were uncorrelated with amounts spent. In her own words, "Without exception, differences in service quality were not found to explain differences in service cost."[14]

What, then, does explain the wide variation in cost of services among the cities. Stevens found that most of the cost differences can be explained by the use of technology and management practices. She concludes that without any change in the level of service and without any reduction in the quality of

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[13]Barbara J. Stevens, "Comparing Public and Private Sector Productive Efficiency: An Analysis of Eight Activities," National Productivity Review, Autumn, 1984, pp. 395-406.

[14]Ibid., pp. 399, 401.

TABLE IV

VARIATION IN COST OF CITY SERVICES
FOR 121 CITIES IN LOS ANGELES COUNTY

SERVICE	LOW-COST CITY	HIGH-COST CITY	DIFFERENCE IN HIGH AND LOW COST
Street Sweeping cost per curb mile swept:	$ 6.24	$ 36.92	592%
Janitorial Service cost per 1,000 sq.ft.:	1.52	10.92	718%
Refuse Collection cost per ton collected:	12.48	43.62	350%
Payroll Preparation cost per check issued:	2.35	10.27	437%
Traffic Signal Maintenance cost per intersection:	843.00	2,801.00	332%
Asphalt Overlay cost per ton laid:	30.65	136.77	446%
Turf Maintenance cost per acre mowed:	39.02	193.46	496%
Street Tree Maintenance cost per trimming visit:	20.25	130.99	647%

SOURCE: Barbara J. Stevens, "Comparing Public and Private Sector Productive Efficiency: An Analysis of Eight Activities," National Productivity Review, Autumn, 1984, p. 398

service, the average city in her study could cut its budget for these services in half. If the cities in and around Los Angeles County are at all representative of cities elsewhere, the implications of these findings for the nation as a whole are staggering.

Is there a way for city governments to set up procedures so that there is a systematic tendency to keep costs at a minimum? The answer is: Yes, by turning to privatization.

THE BENEFITS OF PRIVATIZATION

There is a wealth of evidence that privatization can save governments a lot of money. The fundamental reason centers around competition and business incentives to accomplish a task in the most efficient and effective way, thereby retaining the contract and profiting from it. These profit and loss incentives stand out in stark contrast to the incentives of a government bureau--a monopoly removed from the benefits of competition. Municipal officials have no profit-and-loss ledgers to guide their decision-making. Typically, they are rewarded according to the size of their agencies: the number of employees and the dollar amount of its budget. Their motives are centered around expanding their territory, rather than encouraging efficiency and reducing costs.

A second reason privatization can cut costs has to do with economies of scale. For small-to-medium sized cities, the area and population often is not large enough to take advantage of economies of scale that large government-run services make possible. In these cases it makes sense to purchase the service from a supplier large enough to serve more than one city. On the other hand, for other types of services that same city may be too large to achieve maximum efficiency by using only one supplier. In these cases costs can be lowered if multiple suppliers do the job. Ironically, the one arrangement least likely to be most efficient is the one used by most cities: Services are provided by one supplier (city government) on the scale set by the size of the city.

The presence of multiple suppliers is central to both of the reasons why privatization saves money. Multiple suppliers mean competition. A monopoly that a government-provided service creates is largely insulated from consumer feedback (i.e. people's decisions on where to spend their money) and from producer cost-consciousness. Studies comparing the costs of public service show that the most important factor is not whether the service is delivered publicly or privately, but whether it is delivered by a monopoly or under competition with other providers.

Competition injects a whole new set of disciplines into a service that was previously provided solely by government. Simply having a contract go out to bid for the first time brings almost immediate changes. Local officials often find that the private supplier is far more responsive and careful about service

quality than municipal workers who took it for granted that their department would be providing the service forever.

Garbage collection is one city service that has been studied on a systematic basis. A nationwide study by two Columbia University professors found that government-run solid waste collection was 68 percent more costly than private contracting in cities with populations above 50,000.[15] This study, together with other studies covering the U.S., Canada and Switzerland offer "overwhelming and clear" evidence that private, contracted-out collection is more efficient than municipal collection.[16]

For example,[17]

- A study of 131 Canadian municipalities found municipal collection was more than 50 percent more expensive per household than collection by private contractors.

- Private collection crews were found to be 95 percent more productive.

What is true for garbage collection also appears to hold for many other city services. Again, the most complete and comprehensive study to date is the study of cities in the Los Angeles area. After adjusting for differences in quality of services, level of service, scale of service, etc. Stevens found that:

- When cities do their own street cleaning, the cost is 43 percent higher than the cost for private contractors.

- The cost of city-provided janitorial services is 73 percent higher than when the service is provided by private contractors; for asphalt overlay, the cost is almost two times higher.

- Only in the area of payroll preparation do city governments keep their costs as low as private contractors.

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[15]E.S. Savas and Barbara J. Stevens, Evaluating the Organization of Service Delivery: Solid Waste Collection and Disposal, (New York: Columbia University Graduate School of Business, 1977.)

[16]E.S. Savas, Privatizing the Public Sector, p. 93.

[17]Terry Peters, "Privatization: Public Services and the Private Sector," (Austin, Texas: Texas Research League Analysis, Vol. 5 No. 8, August, 1984) p. 5.

TABLE V

HOW MUCH CAN PRIVATE CONTRACTING SAVE ?
(based on 121 cities in the Los Angeles County area)

SERVICE	EXTRA COSTS AS A RESULT OF CITY PROVISION *
Street Cleaning	43%
Janitorial Services	73%
Refuse Collection	42%
Payroll Preparation	-0-
Traffic Signal Maintenance	56%
Asphalt Overlay Construction	96%
Grass Maintenance	40%
Street Maintenance	37%

* These cost differences are adjusted for differences in the scale of service, quality of service and physical conditions under which the service is provided.

SOURCE: Barbara J. Stephens, "Comparing Public and Private Sector Productive Efficiency: An Analysis of Eight Activities," National Productivity Review, Autumn, 1984, p. 401.

Although there was a significant reduction in the cost of the service, Stevens found no difference in the quality of the service when provided by a private contractor.

How did private contractors manage to keep costs down relative to the city governments? By using more capital, more intensive production methods, and more frequent incentive systems. Also by reducing absenteeism, giving supervisors more authority to hire and fire workers, and holding managers responsible for the maintenance of equipment, etc. In short, by doing many of the things that most business managers would do if they wanted to cut costs.

ALLAYING FEARS ABOUT PRIVATIZATION[18]

Some critics of privatization claim privatization will bring numerous damaging consequences, including higher costs, lost jobs and more corruption. Although it is always possible for a privatization program to be managed poorly, experience indicates that managed correctly, privatization produces good results. The following are a few principles that have been tried and tested in various cities with great success.

1. **Use of private firms should reduce costs.** Frequent and open competitive bidding on contracts will prevent private firms from gradually "padding in" additional costs over time. There are numerous examples of a contracted-out service being switched from one firm to another after a genuinely competitive bidding process. These include paramedic services, data processing, vehicle maintenance, and garbage collection.

2. **Privatization can help eliminate corruption.** The introduction of publicly advertised bidding on contracts (along with objective selection standards) helps eliminate corruption. Decisions that were once concealed from public view (particularly those made by city officials regarding public employee unions) are now out in the open and a matter of public record.

3. **Privatization can create jobs.** When jobs are eliminated in the public sector, resources are freed to create new jobs in the private sector. Frequently, the transfer increases overall productivity. For example, when cities use five full-time employees for a garbage collection crew when three could do the job, they are undermining the productive efforts of two people who could be producing something of value in the private sector. The transition to private suppliers may pose temporary employment problems. However, there are ways to alleviate these problems. One is to require the incoming private firm to give

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[18]This section is based on Robert W. Poole, "Objections to Privatization" in Policy Review (Washington, D.C.: The Heritage Foundation, Spring, 1983).

the displaced government workers first preference for the job openings created by the contract. The federal government's official policy on contracting out already requires this. When a data processing company won a seven-year contract in Orange County, California, it offered all employees a job. More than 98 accepted, although after two years staffing was down to 72 percent. How did the company do it? Not by firing, but by attrition and by transferring workers upward or laterally to other jobs in the company. The opening of new career paths was a key factor in keeping the workers' morale high.

4. **Privatization is politically practical.** Under threat from public employee unions, political leaders may shy away from privatization proposals. However, once the majority of voters see that a particular service is being delivered more efficiently at a lower cost (which smart politicians document and publicize) public support soon materializes. The current tax-revolt attitude of the public coupled with widespread suspicion of public employee unions already is working toward privatization's favor.

5. **Consumers are better served.** Efficiency, responsiveness and service innovation result from privatization. When public services are organized for profit, the benefits of competition (i.e. the threat of a loss of the contract) will accrue. If a new way of performing an old task will save the company money, the company will innovate. One good example is the case of Rural/Metro, the private firefighting company contracted by Scottsdale, Arizona. Rural/Metro pioneered a "portable pipeline" feeding two or three conventional lines from a portable hydrant. The change resulted in significant savings to the city because it could double the spacing between fire hydrants. Rural/Metro also invented a remote control robot for firefighting in dangerous situations.

CASE STUDIES IN PRIVATIZATION SUCCESS

Firefighting. The case of Scottsdale's experiment with private firefighting is one of the oldest and most widely-noted privatization success stories. Scottsdale has had private firefighting (provided by Rural/Metro, Inc.) since 1952. In the mid-1970s a detailed study compared Scottsdale with three other Arizona cities of comparable size. In terms of cost effectiveness, Scottsdale came out way ahead. Over the five-year period from 1971 to 1975, the average annual cost in Scottsdale was $6.48, or only 56 percent of the $11.58 per capita average cost of the other cities.[19]

In addition to Rural/Metro's equipment innovations, the company has made shrewd and brillant changes in the way it uses manpower. The company uses a mix of full-time and reserve firemen. The reservists are less intensively trained, are on call one week a month, and are called only for building

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[19]Poole, "Objections to Privatization."

fires. (Full-time firefighters handle the frequent grass and trash fires.) The reserve firemen are paid only for the time they spend training or responding. Thus, the company's manpower costs are much lower than the city-run fire departments of other cities, even though its wage levels are comparable.

Prisons. Pressed by the escalating costs of housing criminals, many states are turning to the private sector to construct and operate prisons. Nationwide there is a growing list of private firms getting into the correctional industry.

One of the first to enter the field was the Nashville-based Corrections Corporation of America. CCA runs two corrections centers--a community facility for juveniles in Memphis and a processing center for illegal aliens in Houston.

Buckingham Securities, Ltd. of Lewisburg, Pa., has received approval to proceed with the design, construction and operation of a 720-bed penitentiary outside of Pittsburgh. According to officials of the firm, Connecticut, Indiana, Kentucky, Maryland, New Jersey and West Virginia have expressed interest in contracting with the facility once it is finished.

Chief Justice Warren Burger recently called on prison officials to do what they can to transform the nations prisons into "factories with fences."[20] Here again, the private sector already is moving ahead on that front. "Free Venture" is the name of a number of projects launched in the late 1970s in which private firms contract with prison officials for goods or services produced by inmates.

Another unusual privatization experiment in the prison industry is happening in Minnesota. A private, nonprofit data processing company leases space in one of the state's correctional facilities. Inmates do computer programming for firms such as Data Control, 3M, and Honeywell, and can earn as much as $6 per hour.

Entrepreneurs of the private prison business say they can run prisons and jails more efficiently than public agencies. Many experts are cautiously backing the experiments. Said Anthony Travisono of the American Correctional Association, "Many public officials hate running jails and find it attractive to get the problem off their backs while saving tax money."[21]

Education. Sharply falling student scores over the last decade attest to the fact that public education is not doing the job. But while education

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[20] U.S. News and World Report, July 2, 1984, p. 46.

[21] Ibid. p. 45.

quality has gone down, the budgets of schools continue to climb. An indicator of climbing budgets is the proliferation of nonteaching employees in schools. Some 40 percent of all public school employees have nothing to do with teaching--and in some districts that number is as high as 60 percent. Many private schools operate with less than 10 percent nonteaching personnel.[22]

In comparisons of public and private schools, the private institutions usually win out. For example, the city comptroller in New York compared the city's two approaches to educating handicapped children--in public schools and in private schools by contract. The per pupil costs were greater in public schools than in private schools--$6,196 and $4,730 respectively.[23]

- According to a 1980 study, the cost of educating a student in a private school is consistently less expensive than educating a student in public schools.

- By contrast, the average cost of public schooling is $1,740 per pupil, according to the National Center for Educational Statistics.[24]

Private schools are succeeding where public schools fail for a number of reasons, all of which center around the quality of teachers and the students' incentive to learn. In public schools teachers are rewarded according to how many degrees they can accumulate, not how effectively they teach. As for student incentives to learn, declining academic standards have meant thousands of graduates each year cannot read, write, or compute adequately.

For years economists have contended that to improve schools and get equal educational opportunity, the government should issue vouchers that would allow individuals to attend the schools of their choice. Schools would end up competing to attract new students, and presumably would be judged on the quality of their education. Although it is not widely known, Vermont has had a type of voucher system for education for years. Today, 95 of Vermont's 246 towns have no public high school, nor do they belong to any of the state's 27 high school districts.[25]

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[22]Poole, Cutting Back City Hall (New York: Universe Books, 1980) p. 179.

[23]E.S. Savas, Privatizing the Public Sector, p. 102.

[24]Poole, Cutting Back City Hall, p. 184.

[25]McClaughry, "Who Says Vouchers Wouldn't Work?", p. 24.

City Management. If just about every municipal service can be contracted out, what about contracting out the management and administration of the city itself? The contracting out of city management is the newest and most innovative way to shrink government.

In what he describes as "private enterprise competition to bureacracy," a Florida entrepreneur has won contracts with two Florida municipalities to provide management, administration and even clerical services. Another entrepreneur in Florida also is winning city hall contracts to provide management and administrative services.[26]

A third entrant into the field is the California-based Management Services Institute, headed by Douglas Ayres, a former city manager who pioneered the adaptation of private sector cost accounting to government accounting. The company already has completed extensive cost-accounting analysis for many California cities. Its staff is well-qualified. Employees include former city managers, financial directors, city clerks and municipal planners. The benefits of contracting out the management and administration of city governments are similar to the benefits of contracting out almost any other municipal function. They include reduced costs, more accountability, and better service quality. Private firms are able to spread the costs for the same management services among several municipalities. In addition, professional management firms can give more independent recommendations to municipal policymakers than a city manager whose job involves helping to meet the political needs of elected officials.

According to Ayres, injecting an entrepreneurial outlook among city hall bureaucrats usually requires a complete reorientation in thinking because "costs are an alien concept in local government." Nevertheless, the contracting out of city hall operations may become one of the most sought-after methods of cost-cutting through privatization. Reforms such as California's Proposition 4 require the strict accounting of municipal costs, which will necessitate the entry of management firms into this area. In the new climate of cost-consciousness among city bureaucrats, contracting-out may start to look more and more appealing.

THE REAGAN ADMINISTRATION'S PRIVATIZATION STRATEGY

The Reagan Administration's commitment to privatization is best known through its well-publicized attempt to sell Conrail, the federal freight railway. Less well-known, however, are the Administration's efforts to encourage privatization at the local level. For example, the federal government

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[26] Philip E. Fixler, Jr. "Contracting Out Management/Administration" in Fiscal Watchdog bulletin (Santa Barbara, Ca.: Local Government Center, March 1984).

now spends about $870 million per year subsidizing mass transit. However, the Administration has been pressuring the recipients of this aid to look to private sector provision of services as a means of reducing costs.

In December, 1984, a regulation went into effect requiring local governments that get mass transit funds to allow private operators to bid for contracts to operate bus lines and other transit facilities. In addition, the Administration is considering proposing legislation that would require recipients of transit subsidies to turn over at least 20 percent of their operations to private enterprise.

So far, the Administration has made measurable progress on the transit front:[27]

- Private industry has taken over operation of as much as five percent of public mass transit--up from one percent in 1981.
- Nationwide, about 100 private companies now operate mass transit buses on fixed routes.
- Private concerns also operate about 400 van services.
- The cost of private operation averages from 35 to 50 percent less than the cost of public operation.

PRIVATIZATION IN GREAT BRITAIN

Britain is far and away the leader in the world-wide trend toward privatization. Since taking office in 1979, Margaret Thatcher has presided over a vast transfer of government property and activities from the government to the private sector. In the process, both the politics and the economy of Britain have been transformed.

While other countries have just begun to experiment with privatization, the British have honed it to a science. The Thatcher government has employed more than two dozen different techniques to achieve public-to-private transfers: nearly every aspect of British economic life has been changed as a result.

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[27] Martin Tolchin, "Private Concerns Gaining Foothold in Public Transit," New York Times, April 29, 1985. pp. 1,9.

Among the dozens of state-run enterprises that have been wholly or partially transferred to the private sector are the following:[28]

- British Telecom, a hugh government-owned telephone and telegraph company, was sold to the public last November. It was the largest public offering of stock in history. Two million Britons bought shares; about half were first-time investors.

- Nearly 190 million shares of British Leyland (manufacturer of the Jaguar) were sold to the public in 1983. There were traffic jams and fights in the street as potential buyers rushed to apply for the stock.

- The government has sold all of its stock in British Sugar, and 51 percent of its stock in Britoil (North Sea oil exploration) and British Aerospace.

- It has sold almost 40 percent of its stock in British Petroleum, and has sold off subsidiary operations of British Steel, British Rail and British Airways.

- Every city and town in Britain has contracted at least one service out to private firms, and most are contracting out several services.

One of the most successful transfers has been the sale of government-owned housing. When Thatcher took office, one-third of all British housing was owned by the government. Thatcher began selling the houses to the tenants at greatly reduced prices--up to a full 50 percent below the market value. The response since then has been overwhelmingly positive. According to Madsen Pirie, president of the London-based Adam Smith Institute, a behind-the-scenes architect of many privatization programs, the housing sale was the "largest transfer of property since the dissolution of the monasteries by Henry VIII."

The British have even applied the privatization scapel to entitlement programs. Although Thatcher can't claim all of the credit for it (the previous Labour government enacted the law), about half of all British workers have been contracted out of the second tier of Britain's social security system. Under the arrangement, workers are allowed to substitute private pensions for participation in social security.

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[28]Madsen Pirie, Dismantling the State: The Theory and Practice of Privatization (Dallas: National Center for Policy Analysis, April, 1984).

A recent Background Briefing released by the British Treasury says that privatization "ranks among the most radical reforms of the UK's economic and industrial structure since 1945."[29] The government's record thus far supports this claim:

- Nationalized industries once accounted for 10 percent of Gross Domestic Product and one-seventh of total investment in the economy. The government has sold more than $5.5 billion of stock in nationalized companies and intends to continue selling at the rate of about $2 billion a year.

- When Thatcher took office, nationalized industries employed 1.5 million people and dominated the transport, energy, communications, steel and ship-building sectors of the economy. To date, more than 400,000 jobs--almost one-third of the total nationalized work force have been transferred to the private sector.

CONCLUSION

The growth of government can be halted and reversed by privatization. Dozens of U.S. cities already are experimenting with privatization (some on a large scale) as a means of improving city services and controlling their costs. Privatization is a solution for other reasons as well. It can create jobs. Consumers are better served. And it is politically practical.

The U.S. can look toward Britain as a privatization role model. In the last five years Prime Minister Margaret Thatcher has been "dismantling the state" on a massive scale, proving that even in countries which have strong socialist backgrounds privatization can work, and with support from the voters.

NOTE: Nothing in this report should be construed as necessarily reflecting the views of the National Center for Policy Analysis or as an attempt to aid or hinder the passage of any bill before Congress or any state legislature.

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[29]British Treasury, "Privatization in the United Kingdom", January, 1985.

APPENDIX

PRIVATIZATION IN TEXAS

A 1982 survey revealed that contracting-out is becoming an established practice among Texas cities. Of 50 major city services, 45 are being provided by private firms in at least one Texas city.

- Ninety-five percent of Texas cities contract with the private sector to perform at least one service.[30]

- Nearly every municipal service is being contracted out to some extent by Texas cities.[31]

The survey found that a relatively small number of municipal services account for most of the private sector contracting. (Of the 1,042 contracts issued by Texas cities, 23 types of services accounted for 90 percent of all contracts). The most frequently contracted out services are listed in Table IV.

Although contracting with private firms is a common practice among Texas cities, in many areas Texas is well behind the rest of the country in its privatization efforts:[32]

- Garbage is collected by private contractors nationally three times more frequently than in Texas.

- Ambulance services are contracted out nationally at twice the rate of Texas.

- In transportation, half of U.S. cities have private contracts for some form of public transportation, yet only four Texas cities have contracts of this kind.

Table VII indicates that not only does Texas lag behind the rest of the country in privatization, it also lags behind neighboring southern and western states.

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[30]David W. Tees and Stanley E. Wilkes, Jr., The Private Connection: A Texas City Official's Guide for Contracting With the Private Sector (The University of Texas at Arlington: Institute for Urban Studies, December, 1982), p. 11.

[31]Ibid. p. 15.

[32]The Private Connection, p. 15.

TABLE VI

SERVICES FREQUENTLY CONTRACTED OUT BY TEXAS CITIES

Service	Percent Contracting
Engineering	65%
Legal	48%
Architectural	36%
Street Lighting	35%
Garbage Collection	33%
Street Construction and Maintenance	27%
Ambulance Service	23%
Mapping	22%
Tax Collection	21%
Utility Billing	15%
Planning	15%
Police Training	15%
Water Supply	11%
Building and Mechanical Inspection	11%

SOURCE: David W. Tees and Stanley E. Wilkes, Jr., The Private Connection: A Texas City Official's Guide for Contracting With the Private Sector (Arlington, Texas: Institute for Urban Studies, University of Texas at Arlington, 1982), p. 12.

TABLE VII

PRIVATIZATION: TEXAS VS. THE REST OF THE NATION
(late 1970's)

REGION	AVERAGE NUMBER OF CONTRACTS PER CITY
North Central	9.0
North East	7.0
West	6.0
South	5.8
Texas	5.0

SOURCE: Patricia S. Florestano and Stephen B. Gordon, "Public vs. Private: Small Government Contracting with the Private Sector," Public Administration Review, January/February, 1980, p. 30. Cited in David W. Tees and Stanley E. Wilkes, Jr., The Private Connection: A Texas City Official's Guide for Contracting with the Private Sector (Arlington, Texas: Institute for Urban Studies, University of Texas at Arlington, 1982), p. 16.

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Mr. FAUNTROY. You also, in touching on that point, raise with me the question of our requirement here in the District of Columbia that new employees reside in the District of Columbia, and we as a local government strongly encourage present employees to reside here. If the District chose to privatize certain services, a number of those city residents as well as residents from the surrounding jurisdictions would lose their jobs. What would you suggest be done for these District employees?

Mr. BARTLETT. One would presume that many, if not most, of them could be hired by whoever is contracted for to provide the same service. It is really an issue of management more than anything else. The reason why the private sector is able to provide services at a lower cost is because they don't have the regulations and many of the other kinds of things that make it difficult to set your pricing, for example.

If you were trying to figure out how to price a fee let us say for some service, any kind of governmental service, it is very hard to figure out what the comparable price would be, because a governmental entity doesn't pay taxes to itself, so you don't have to worry about paying taxes. The overhead cost is in many ways very hard to calculate. The capital, the cost of the capital to acquire the machinery or equipment to provide services is hard to calculate as well, many times, and therefore I think it is really a management issue and not one of just trying to throw people out of work or anything like that.

It is a question of who will provide the service rather than whether the services will be provided. Again, I would assume that to the extent that these services are needed and will be provided, employment will be created in the private sector rather than the public sector. That is the only real difference that I would see.

Mr. FAUNTROY. Thank you, Mr. Bartlett. I cannot emphasize enough the value of your testimony for our Subcommittee on Fiscal Affairs on the budget. If we could get an assessment of what type services in other jurisdictions have been privatized and effect savings, because I am sure both the committee and the District government and the council would benefit from that, and could assess how privatization could prove to be a cost-effective way of delivering services. They may apply those principles and experiences here in the District of Columbia.

Mr. BARTLETT. Thank you.

Mr. FAUNTROY. Mr. Bartlett, counsel has requested permission to ask a question.

Mr. HOBSON. Among the things you listed that are privatized, for example, you listed towing. My understanding is that the District of Columbia is considered to be the best in the Nation when it comes to ticketing and towing, even better than New York. In the material that you submit to us at a later date, could you also, if you can, make some assessments of those areas that are more efficient than others in terms of what they will save? It would seem that towing in the District is already done efficiently by the government and generates a considerable amount of revenue.

Mr. BARTLETT. What I am suggesting, the sort of thing I am talking about would be the District police or whoever gives out the tickets would continue to give out the tickets, but rather than

having a District-owned truck come and tow the car, you might well contract with a private firm on say a per vehicle basis to do this towing, and then it would simply be a matter of comparing the cost. It may very well be, and I don't deny the possibility, that a local government could provide services more efficiently and at a lower cost than a private firm.

The only question is how do you know unless you have some method by which you can compare what the private sector would be in fact willing to charge to provide the service, and you could certainly have some sort of system where a governmental entity—you could put something up for bid, let us say, the towing of vehicles, let us say, and you could have the District towing authority, whatever it is, make a bid, with serious cost estimates honestly done of what the actual cost would be, and compare it to what private sector bids might be, and it might turn out that a governmental entity is in fact the best way to do it. But the prospect of possibly having competition in the future I think would be a very strong incentive to keep costs as low as possible, and I believe this is a method which has been used elsewhere very efficiently.

Mr. FAUNTROY. We thank you.

Now we have a very distinguished panel of three witnesses, Mr. Philip Dearborn, vice president of the Greater Washington Research Center, and an individual who has contributed much to our data base for decisions in both local government and the District Committee, Mr. Matthew Watson, who is attorney at law and former auditor for the District of Columbia government. Is that right?

Mr. WATSON. That is right.

Mr. FAUNTROY. And Irv Nathan, chairman of the board of trustees of the National Capital Region of the American Jewish Congress. We are happy to have all three of you here. We look forward to your presentation on this as well.

Mr. Dearborn, if you will begin. Proceed in whatever manner you choose.

STATEMENTS OF PHILIP DEARBORN, VICE PRESIDENT, GREATER WASHINGTON RESEARCH CENTER; MATTHEW WATSON, ATTORNEY AT LAW; AND IRV NATHAN, CHAIRMAN, BOARD OF TRUSTEES, NATIONAL CAPITAL REGION, AMERICAN JEWISH CONGRESS:

STATEMENT OF PHILIP DEARBORN

Mr. DEARBORN. Thank you, Mr. Chairman. My statement is somewhat longer than I usually present and therefore I will highlight it. It is based on research and a report that we issued on the effects of tax reform on the Washington area last week.

The loss of deductibility for State and local taxes on the Federal tax return is obviously a very complex thing to evaluate. If it were only the effect of loss of deductibility that we were evaluating, I think there would be no question that it would be adverse to the District of Columbia, both the government and the residents of the District. However, the loss of deductibility is part of an overall package and that makes this whole problem much more difficult to evaluate.

Before getting to the effects on the District government, let me just briefly review how it affects individuals.

The President's proposal is estimated to reduce taxes on individuals $26 billion through essentially a doubling of exemptions, changes in the tax rates, changes in the tax brackets. On the other hand, there are some provisions in here which cause taxes to be increased for individuals in addition to the deduction of State and local taxes and the loss of the Maryland deduction and other things that come into play. The end result is that most taxpayers will receive a tax deduction because of this $26 billion total reduction. All nonitemizing taxpayers will get a deduction, and of those that do itemize, a substantial number in the District as well as other places will also get one.

The biggest exception to this will be two-earner families under certain circumstances who will get an increase. We did a rough calculation, for instance, and at the $75,000 level a two-earner family in the District would appear to pay about $370 more in taxes under the President's tax proposal, and a much smaller amount in addition in Montgomery County.

The local taxes as a result of doing away with the deduction will vary, the amount of the tax reduction or tax increase will vary by the amount of the local taxes in the local metropolitan area. I won't go through the calculations. They are in the prepared statement. The net result is that the reduction in taxes for a one-earner family of four—which I hasten to add is not a typical family in the Washington area, but it is one for which we have good information—but the reduction for that family in Arlington, for instance, would be almost $2,000, whereas in the District of Columbia that same family would get a reduction of only about $1,200.

Now, it is apparent from the illustration that the tax reductions resulting from the proposed tax changes will vary substantially both in dollar amount and in the percent of change depending on both income level and place of residence. Let me elaborate on this a little bit, because I think it is an important thing.

At the $75,000 and $35,000 income levels when deductions are itemized, the tax change will be inverse to the size of the State and local tax burden under the present law. In other words, those with the highest State and local tax burden by income class will get the least reduction, or in some cases the most increase.

For some itemizing taxpayers, this will mean a decrease in a low-tax jurisdiction where a comparable taxpayer in a higher tax jurisdiction will receive a tax increase. Because of this variance in effect resulting from differences in State and local tax burdens, the difference in total Federal, State, and local tax burdens in a metropolitan area will be magnified. This can be illustrated by examining what happens to the difference in total tax burden between the District of Columbia and Arlington County. At the $75,000 gross income level, the family in the District of Columbia pays 1.7 percent more of its income for taxes under the current law than a similar family in Arlington.

Currently, they pay 1.7 percent difference. Under the proposed law, the District of Columbia family would pay 2.6 percent more, or an increase of $750 in the disparity. At the lower income levels the increase in the disparity is less significant, going from 1.4 percent

to 1.8 percent at the $35,000 income level and unchanged at 0.4 percent at the $10,000 level. This smaller change results because the steeper progressivity in the District's income tax rates causes total State and local taxes to increase more rapidly for higher income taxpayers in the District than in Virginia.

With that background let me then discuss with you a few of the effects of the change on local governments. The first one is obvious. It will increase local tax disparities. I think this will disturb the taxing equilibrium that currently exists in the metropolitan area. Local governments with relatively high tax burdens such as the District will find it necessary to change or reduce their taxes to remain competitive with neighboring jurisdictions.

Since the disparity is increased only for itemizers who typically have higher incomes and own homes, the District of Columbia may find it necessary to shift tax burdens away from them and onto lower income renters or, as the Mayor indicated, suffer an actual loss of revenue if they don't make this shift but merely provide tax relief for those high-income itemizers.

The second thing, indirect effect on city governments—which is not in my prepared text, because I only concluded that it would occur yesterday after I had done this—is a decrease in property tax values in the District of Columbia. Now, this occurs because the loss of the property tax deduction will inhibit people who are currently renters from buying homes, and because those who currently own homes will be inhibited in moving up in value.

The National Association of Home Builders has estimated that the decrease in property value might be 5 percent. I have reviewed their numbers, and I believe that is a reasonable figure, and because the District assesses property annually, the 5-percent reduction in owner occupied residential values would probably be reflected fairly quickly and fairly directly in District property values.

There would be, as one other speaker talked about, a broadening of the income tax base in the District if the District did not change its rates or its base. It would receive a windfall revenue gain from this. I believe the District would have to change its rates or its base in order to keep its income tax neutral. I believe that would primarily occur through a reduction in the upper brackets in order to stay competitive with Maryland and Virginia.

Two other effects, one of which has been mentioned. The District would, of course, find that it was no longer penalized from using user fees as a means of raising revenues and might go more in the direction of user fees, although I agree with the Mayor there would be not a great deal of opportunity for this, but it would find that it could do so without being penalized.

The second possibility would be the greater use of business taxes in the District, which will remain deductible. The District has a classified property tax with multifamily and commercial property tax rates. There might be a tendency of the District to make greater use of those and shift more onto the commercial base, which in turn remains deductible. However, this could only be done in a way that would keep the District competitive with surrounding jurisdictions and might not provide a great deal of potential.

I believe there will be some reduction in city spending, some pressure on the city to reduce its spending, although it's hard to

calculate exactly how much pressure may be put on the city as a result of loss of deductibility. Some have suggested it might average 2 or 3 percent. It might be a few percent more, I believe, in the District.

There will be benefits to low-income taxpayers in the District as a result of the significant tax decrease for those low-income people who rent and for those who don't itemize. The National Association of Home Builders has suggested this may be offset, however, after several years by an increase in the rent because of the workings of other aspects of the tax reform package.

The effects on the local economy I could not calculate because there are too many things going on in this tax proposal. I believe there would be a benefit to the District in the tax reduction on individuals. There would be some offsetting increases and effects on construction and on commercial property taxpayers. The District may be in a better position than some other central cities, however, because it does not have major manufacturers who would be the most heavily hit by the shift of the $267 billion to the corporate sector.

In conclusion, then, I think the loss of State and local tax deductibility, when taken in concert with the President's other tax proposals, will have a variety of effects on the District government and its residents. Some effects are favorable, but there are also offsetting unfavorable results. The lack of information, both at the national and local levels, makes it very difficult to determine how it will fare. Nevertheless, it is possible to conclude that the District will experience the following general results: A less favorable competitive tax position relative to suburban governments; pressure to reduce the progressivity in its income tax structure; reduced tax burdens on its low-income wage earners; and pressure to reduce government spending.

[The prepared statement along with attachments of Mr. Dearborn follow:]

TESTIMONY OF PHILIP M. DEARBORN
BEFORE THE SUBCOMMITTEE ON FISCAL AFFAIRS AND HEALTH
OF THE COMMITTEE ON THE DISTRICT OF COLUMBIA
JULY 12, 1985

The President has proposed to eliminate the deductibility of state and local income, sales, and property taxes from individuals' incomes for purposes of calculating federal tax liability. This proposal, if enacted, will directly affect virtually every District of Columbia taxpayer who itemizes deductions. It will also indirectly affect the government of the District of Columbia in several important ways. The effects of loss of deductibility would obviously be negative for both individual taxpayers and the city if done in isolation, but because the President proposes other actions that will mitigate the loss of deductibility, the total effects of the tax proposal are not readily apparent. The proposal is very complex and the information necessary to analyze many effects in detail is not readily available. Nevertheless, this examination will provide some preliminary observations and conclusions about the effects of loss of state and local tax deductions as proposed in the President's tax package.

It is first necessary to examine the changes in individual tax burdens resulting from the deductibility loss and other changes in the tax proposal. After examining how residents of the District of Columbia are affected, it is then possible to speculate about how the city government and its economy is affected.

1. Changes in Tax Burdens on City Residents

General Effects on Residents

The President's proposal is estimated to reduce taxes on individuals by $26 billion in fiscal 1987. This reduction in taxes occurs primarily as a result of the reduction in tax rates, changes in tax brackets, and almost doubling the taxpayer and dependent exemption from $1,080 to $2,000. How-

ever, features of the proposal, such as the elimination of the deduction for state and local taxes, the loss of the marital deduction, and other changes, will offset the reductions for some taxpayers.

Most taxpayers will receive a tax reduction from the proposals. This occurs because virtually all non-itemizing taxpayers will receive a tax reduction, and nationally about two-thirds of all taxpayers do not itemize. The percent of non-itemizers may be even higher in many central cities, because large portions of their population consist of lower income renters. Of those who do itemize some will also receive a tax reduction, but some will get a tax increase depending principally on income level, amount of state and local taxes paid, and family characteristics. Most families with children, or only one wage earner, who itemize deductions will receive a reduction.

In contrast, in some jurisdictions a two-earner family with no children would pay more taxes[1]. The increase occurs because the loss of the state and local tax deduction and the two-earner marital deduction would not be sufficiently offset by the lower rates and increased exemption.

It is family size, income levels, and tax characteristics of individuals, when combined with state and local tax burdens, that will determine the effects of the proposed tax reform on those who itemize. There are an almost unlimited number of possible conbinations of family size, income, and other tax characteristics. Therefore, generalizing about the circumstances under which a tax increase instead of a decrease will occur is extremely difficult.

[1]For example, a rough calculation in the Washington, D.C. area estimated such a family with a $75,000 income would pay additional taxes of $371 in D.C., and $24 in Montgomery County, but in Arlington County the same family would receive a $376 reduction (for the calculation of these changes see Appendix 1).

Variance in Effects Among Jurisdictions in A Metropolitan Area

Local taxes vary by jurisdiction within a metropolitan area, so the amount and percent of tax reduction (or tax increase) for individuals who itemize deductions will vary by place of residence. To illustrate how this occurs, all taxes federal, state, and local for a hypothetical family of four at three different income levels were calculated in the Washington, D.C. metropolitan area for three jurisdictions, first under the current federal tax law and then under the proposed tax law. This was done using the state/local tax burdens in the District of Columbia, Arlington County, Virginia, and Montgomery County, Maryland[2].

More detailed calculations can be found in Appendices 2-4, but the results can be summarized as follows:

Total State, Local, and Federal Taxes
Family of Four, One Wage Earner
Selected Washington Area Jurisdictions
1986 Tax Year

	Current Law	Proposed Law	Change Number	Change Percent
$75,000 Gross Income				
District of Columbia	$21,224	$19,991	-$1,233	-5.8%
Arlington County	19,987	18,007	-1,980	-9.9
Montgomery County	20,589	19,008	-1,581	-7.7
$35,000 Gross Income				
District of Columbia	7,003	6,512	-491	-7.0
Arlington County	6,509	5,881	-628	-9.6
Montgomery County	7,037	6,566	-471	-6.7
$10,000 Gross Income				
District of Columbia	1,087	866	-221	-20.3
Arlington County	1,051	830	-221	-21.0
Montgomery County	990	769	-221	-22.3

[2]The illustrations are based on the taxpayer profiles used by the District of Columbia Department of Finance and Revenue in its annual comparative tax burden study for the Washington area. Because the District study computes tax burdens only for a family of four with one-wage earner, the comparison does not show the results for other types of families, or single taxpayers.

It is apparent that the tax reductions resulting from the proposed federal tax changes will vary substantially both in dollar amount and in the percent of change, depending on both income and place of residence. At the $75,000 and $35,000 income levels, when deductions are itemized, the tax change will be inverse to the size of the state and local tax burden under the present law, i.e., those with the highest state and local tax burden by income class will get the least reduction. For some itemizing taxpayers this could mean a tax decrease in a low tax jurisdiction, while a comparable taxpayer in a higher tax jurisdiction would receive a tax increase. Because of this variance in effect resulting from differences in state and local tax burdens, the differences in total federal, state and local tax burdens in a metropolitan area will be magnified.

This can be illustrated by examining what happens to the difference in total tax burden between the District of Columbia and Arlington County. At the $75,000 gross income level the family in the District of Columbia pays 1.7 percent more of its income for taxes under the current law than a similar family in Arlington. Under the proposed law, the District of Columbia family would pay 2.6 percent more or an increase of $750 in the disparity. At the lower income levels the increase in the disparity is less significant, going from 1.4 percent to 1.8 percent at the $35,000 income level and unchanged at 0.4 percent at the $10,000 level. This smaller change results because the steeper progressivity in the District's income tax rates causes total state local taxes to increase more rapidly for higher income taxpayers in the District than in Virginia.

2. Indirect Effects on City Governments

Increase in Local tax Disparities

The increase in the disparity in total tax burdens in the Washington area will disturb the tax equilibrium that currently exists. Quite simply, people currently accept higher taxes in the District in return for better services, commuting convenience, or other reasons. At the higher relative costs imposed by loss of deductibility, some taxpayers may find the benefits not worth the increased taxes. As a result, there may be an increased incentive for higher income people to locate outside the District.

Local governments with relatively high tax burdens, such as the District, may find it necessary to change or reduce their taxes to remain competitive with neighboring jurisdictions. Since the disparity is increased only for itemizers, who typically have higher incomes and own homes, the affected cities may find it necessary to shift tax burdens away from them and onto lower income renters. This will mean less progressivity in city tax systems.

Broadening of State Income Tax Bases

The changes proposed in both the federal individual and corporate income taxes are designed to reduce tax rates without any overall loss of revenues. To do this requires a broadening of the tax base by closing so-called loopholes. A simple example illustrates how this works. A 20 percent tax on a $100 million tax base yields $20 million. To reduce the tax rate to 16 percent and still keep the yield at $20 million would require that the base be broadened to $125 million.

Many states[3] use the federal tax base for individual and corporate income taxes as a starting point for calculating their state income taxes, so that increasing the federal tax base may increase their tax bases[4]. Therefore, if no changes are made in general comparability of those states' tax bases to the federal base and no change in rates occurs, the governments' total tax revenues may increase by substantial amounts. For example, an informal estimate suggests that purely as a result of the federal tax proposal, District of Columbia income tax revenues would increase by $34 million, if the city continued to parallel the federal base and impose its current rates.

Because most states and the District are in a relatively comfortable budget position at the present time, it is unlikely that they would plan to actually receive such a large revenue windfall. As a result, they can be expected to either adjust their individual and corporate income tax rates to make them yield about the same revenues as they would have received if the federal tax changes had not occurred, or to use the increased income tax revenues to offset other effects of the tax reform package. For example, the District might use its increased income tax revenue to help alleviate the increased burden of local property taxes, to replace lost economic development incentives in cities, or to assist specific groups of taxpayers disadvantaged by the federal changes.

[3]Of the 47 states with personal income taxes, 35 compute state tax liability from a point on the federal tax return. Appendix 5 is a list of states with income taxes and shows their relationship to the federal tax return.

[4]This increase in state income tax bases would not be as dramatic at the state level as it would be at the federal level. One of the major federal base broadeners is removal of the deductibility of state and local income taxes--a deduction that was already not allowed in most state income tax bases.

Other Effects on Taxes

Two other possible effects on state/local revenue structures may occur. Under the current federal tax laws there is an incentive to use income, property, and sales taxes to finance state and local governments because these taxes are deductible. This feature of the federal tax system has inhibited the use of alternative revenue sources, such as user charges, because they are not deductible. Thus, the proposed changes may result in a greater use of alternative revenue sources by the District.

A second possibility is that because business taxes paid to state and local governments will continue to be deductible from business income, state and local governments will increase the business tax burden. However, competitive considerations may make this impossible unless competing Maryland and Virginia jurisdictions act in concert.

Reductions in City Spending

Economists have suggested that state and local government goods and services will increase in cost to taxpayers, at least to those that itemize deductions, because taxpayers will no longer receive an indirect federal subsidy for such purchases. The reasoning is as follows: each dollar an itemizing taxpayer pays in state or local taxes buys a dollar worth of state or local services, but because the dollar is deductible in calculating federal taxes, it may only actually cost the taxpayer in the 50 percent bracket as little as fifty cents. Thus, the taxpayer has bought a dollar's service for fifty cents.

With the elimination of state and local tax deductions the cost of state and local government services would be increased to the full dollar paid in taxes. It is theorized that the taxpayers who itemize (perhaps one-third) would thus put additional pressure on state and local governments to reduce spending.

While economists think eliminating state/local tax deductability would mean some pressure to reduce state and local government spending, they disagree on how much. A recent estimate is that it would probably be a reduction of only 2 to 3 percent, and this reduction would occur only over several years in the form of lower-than-expected expenditure growth. The actual effects on the District will depend on the number of taxpayers who itemize, the size of the deductible local tax burdens, the reliance on currently deductible taxes relative to non-deductible sources of revenue, and the sensitivity of officials to political pressures. At this time is impossible to assess what reductions in District spending will result from the loss of deductibility.

Benefits to Low-Income Residents

Another more direct spending effect from the tax proposal may come from the relatively large amounts of tax reduction for those families near the poverty level. A major concern of the District government, and a target for a variety of health, housing, and income maintenance programs, have been the working poor, that is, those whose incomes are too low to purchase adequate shelter, health care, and other necessities. The direct

benefits these residents would obtain from the tax proposal should decrease some of the pressure on the District government to provide additional assistance to low income people. In restructuring the city's income taxes as a result of the broader federal base discussed earlier, the District could also reduce tax rates on low income residents, such actions could further ease spending pressures for such programs.

3. Effects on the Local Economy

If the amount of local incomes that are paid in taxes by District residents decreases, the amount available to be spent or invested by them in local businesses increases. This could result in a stimulus to the local economy. For example, in the Washington area, if overall tax burdens on area residents decrease by an average 1.0 percent (i.e., they have 1.0 percent more income to spend for private purchases or investment), about $350 million in purchasing power would be added to the local economy. Since government revenues would not be reduced by the proposed changes, there should be no immediate decrease in government spending. However, because the reduction in taxes on individuals would be offset by increases in taxes on businesses and by increases for some itemizing taxpayers, many cities will find what they gain in individuals' increased purchasing power is more than offset by the higher taxes paid by local businesses and itemizing taxpayers.

Information is not available to determine exactly how the District would fare economically when the increased individual incomes are weighed against the decreased business incomes. However, it is likely that the District would benefit because it ranks low in major manufacturing corpora-

tions, the primary recipients of tax increases; and has a strong preponderance of service businesses that are least likely to be affected by changes in business taxes. On the other hand the high levels of construction activity in the District would probably be adversely affected by the tax changes. In addition, the District may also have a relatively large number of itemizers with family characteristics that could cause them to pay more taxes. To further complicate any evaluation of the economic effects there will be long-term consequences for housing and economic development that cannot be easily quantified.

Thus, although it is possible that the District would benefit economically from the tax proposals, more research is necessary before any definite conclusion can be reached.

Conclusions

To sum up, the loss of state and local tax deductibility when taken in concert with the President's other tax proposals will have a variety of effects on the District government and its residents. Some effects are favorable, but there are also offsetting unfavorable results. The lack of information, both at the national and local levels, makes it very difficult to determine how it will fare. Nevertheless, it is possible to conclude that the District will experience the following general results:

- A less favorable competitive tax position relative to suburban governments.
- Pressure to reduce the progressivity in its income tax structure.
- Reduced tax burdens on its low income wage earners.
- Pressure to reduce government spending.

Appendix 1
Change in Taxes
Two-Earner Family*
Income $75,000*, No Dependents
1986 Tax Year

	Current Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$75,000	$75,000	$75,000
Exemptions (2)	-2,160	-2,160	-2,160
Deductions	-7,363	-7,363	-7,363
S/L Taxes	-8,612	-6,646	-7,697
IRA	-4,000	-4,000	-4,000
Capital Gains	-1,800	-1,800	-1,800
Marital Deduction	-2,000	-2,000	-2,000
Zero Bracket Amount	+3,670	+3,670	+3,670
Taxable Income	$52,735	$54,701	$53,650
Federal Tax	11,788	12,535	12,135
S/L Taxes	8,832	6,848	7,849
Total Taxes	$20,620	$19,383	$19,984
% of Gross Income	27.5%	25.8%	26.6%

	Proposed Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$75,000	$75,000	$75,000
Exemptions (2)	-4,000	-4,000	-4,000
Deductions	-6,863	-6,863	-6,863
S/L Taxes	- 0 -	- 0 -	- 0 -
IRA	-4,000	-4,000	-4,000
Capital Gains	-1,500	-1,500	-1,500
Zero Bracket Amount	+4,000	+4,000	+4,000
Taxable Income	$62,637	$62,637	$62,637
Federal Taxes	12,159	12,159	12,159
S/L Taxes	8,832	6,848	7,849
Total Taxes	$20,991	$19,007	$20,008
% of Gross Income	28.0%	25.3%	26.7%
Amount of Change	+371	-376	+24
% Change	+1.8%	-1.9%	+.1%

*Assumes two-wage earners, ($20,000 and $46,500), family of two, $3,000 of capital gains income, $5,500 of net interest expense

Source: The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1, 1985.

A Comparison of Tax Rates and Burdens in the Washington Metropolitan Area, D.C. Department of Finance and Revenue, June, 1984.

Appendix 2
Change in Taxes
Current Law/Proposed Law
$75,000 Gross Income*
1986 Tax Year

	Current Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$75,000	$75,000	$75,000
Exemptions (4)	-4,320	-4,320	-4,320
Deductions	-7,363	-7,363	-7,363
S/L Taxes	-8,612	-6,646	-7,697
IRA	-2,250	-2,250	-2,250
Capital Gains	-1,800	-1,800	-1,800
Zero Bracket Amount	+3,670	+3,670	+3,670
Taxable Income	$54,325	$56,291	$55,240
Federal Tax	12,392	13,139	12,740
S/L Taxes	8,832	6,848	7,849
Total Taxes	$21,224	$19,987	$20,589
% of Gross Income	28.3%	26.6%	27.5%

	Proposed Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$75,000	$75,000	$75,000
Exemptions (4)	-8,000	-8,000	-8,000
Deductions	-6,863	-6,863	-6,863
S/L Taxes	- 0 -	- 0 -	- 0 -
IRA	-4,000	-4,000	-4,000
Capital Gains	-1,500	-1,500	-1,500
Zero Bracket Amount	+4,000	+4,000	+4,000
Taxable Income	$58,637	$58,637	$58,637
Federal Tax	11,159	11,159	11,159
S/L Taxes	8,832	6,848	7,849
Total Taxes	$19,991	$18,007	$19,008
% of Gross Income	26.6%	24.0%	25.3%
Amount of Reduction	-1,233	-1,980	-1,581
% Reduction	-5.8%	-9.9%	-7.7%

*Assumes one wage earner, family of four, $3,000 of capital gains income, $5,500 of net interest expense.

Source: The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1, 1985.

A Comparison of Tax Rates and Burdens in the Washington Metropolitan Area, D.C. Department of Finance and Revenue, June, 1984.

Appendix 3
Change in Taxes -
Current Law/Proposed Law
$35,000 Gross Income*
1986 Tax Year

	Current Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$35,000	$35,000	$35,000
Exemptions (4)	-4,320	-4,320	-4,320
Deductions	-3,999	-3,999	-3,999
S/L Taxes	-3,526	-2,900	-3,617
IRA	-2,250	-2,250	-2,250
Capital Gains	- 0 -	- 0 -	- 0 -
Zero Bracket Amount	+3,670	+3,670	+3,670
Taxable Income	$24,735	$25,361	$24,644
Federal Tax	3,341	3,478	3,321
S/L Taxes	3,662	3,031	3,716
Total Taxes	$7,003	$6,509	$7,037
% of Gross Income	20.0%	18.6%	20.1%

	Proposed Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$35,000	$35,000	$35,000
Exemptions (4)	-8,000	-8,000	-8,000
Deductions	-3,999	-3,999	-3,999
S/L Taxes	- 0 -	- 0 -	- 0 -
IRA	-4,000	-4,000	-4,000
Zero Bracket Amount	+4,000	+4,000	+4,000
Taxable Income	$23,001	$23,001	$23,001
Federal Tax	2,850	2,850	2,850
S/L Taxes	3,662	3,031	3,716
Total Taxes	$6,512	$5,881	$6,566
% of Gross Income	18.6%	16.8%	18.8%
Amount of Reduction	-491	-628	-471
% Reduction	-7.0%	-9.6%	-6.7%

*Assumes one wage earner, a family of four, no capital gains income, $2,000 of interest income.

Source: The President's Tax Proposals to the Congress for Fairness, Growth, and Simplicity, May 1, 1985.

A Comparison of Tax Rates and Burdens in the Washington Metropolitan Area, D.C. Department of Finance and Revenue, June, 1984.

Appendix 4
Change in Taxes
Current Law/Proposed Law
$10,000 Gross Income*
1986 Tax Year

	Current Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$10,000	$10,000	$10,000
Exemptions (4)	-4,320	-4,320	-4,320
Taxable Income	$5,680	$5,680	$5,680
Federal Tax (tax table)	221	221	221
S/L Taxes	866	830	769
Total Taxes	$1,087	$1,051	$990
% of Gross Income	10.9%	10.5%	9.9%

	Proposed Law		
	District of Columbia	Arlington County	Montgomery County
Gross Income	$10,000	$10,000	$10,000
Exemptions (4)	-8,000	-8,000	-8,000
Taxable Income	$2,000	$2,000	$2,000
Federal Tax	- 0 -	- 0 -	- 0 -
S/L Tax	866	830	769
Total Taxes	$866	$830	$769
% of Gross Income	8.7%	8.3%	7.7%
Amount of Reduction	-221	-221	-221
% of Reduction	-20.3%	-21.0%	-22.3%

*Assumes one wage earner, family of four, no capital gains income, no interest income.

Source: The President's Tax Proposals to the Congress for Fairness, Growth , and Simplicity, May 1, 1985.

A Comparison of Tax Rates and Burdens in the Washington Metropolitan Area, D.C. Department of Finance and Revenue, June, 1984.

Mr. FAUNTROY. I thank you so much, Mr. Dearborn. We cannot express enough our appreciation to the Greater Washington Research Center for what is obviously a thoroughly objective and apparently scientifically verifiable assessment of what the actual impact of not simply the State and local deductions but the entire range of proposals made by the President would be upon the District of Columbia. For that we are very grateful.

We will move to our next witness before we go to questions. Mr. Matthew Watson, it is a real pleasure to have you again. You have had such a long and distinguished career in the District of Columbia, assisting us in not only shaping our local government but improving the quality of the delivery of service.

STATEMENT OF MATTHEW S. WATSON

Mr. WATSON. Thank you, Chairman Fauntroy. I have submitted a prepared statement and I would like to comment on several points of it partly with regard to what the testimony from Heritage Foundation was as to how they looked at taxes.

Mr. FAUNTROY. May I interrupt you just a moment to say that Mr. Dearborn's statement will be included in its entirety at the conclusion of his statement in the record, and the same for you, Mr. Watson.

Mr. WATSON. Thank you.

I find interesting that people who discuss in this administration, who discuss this federalism and the new federalism tend to ignore it when it comes to not being in their benefit and not wanting to look at it, and what has come across here is this notion that high-tax States are being subsidized by low-tax States, which in actual fact is probably the exact reverse, largely because the low-tax States, or what appear to the low-tax States, have very often found, because of different economic advantages they have, the ability to directly export their taxes, which is why I found quite interesting his comments, for instance, with regard to Wyoming and Alaska. It will have virtually no effect from the President's tax proposal on their tax revenues.

Both Wyoming and Alaska achieve more than 50 percent of their total State revenue from what are known as severance taxes, which are taxes on natural resources, principally oil and gas. It is interesting with these sorts of severance taxes that although we suffer a restriction in the District on collection of a commuter tax, of people who come into the District of Columbia several hundred days a year, I have never set foot, for instance, in the State of Texas. Because of where Washington Gas buys its gas, during the winter months I am paying in direct Texas taxes over $1 a month on my gas bills.

The State of Texas is collecting more than a quarter of its revenue principally from gas and oil taxes. It makes our Federal payment look quite puny. The State of Texas collects close to $2.5 billion a year from the rest of the country by way of severance taxes.

There are eight States in the Union who in these severance taxes on gas and oil collect more than 25 percent of their revenue from the other 48 States and the District of Columbia, because the State of Alaska, being one of the other two States, is collecting 61 per-

cent of its revenue from oil and gas. So what we have is a situation of these States with no personal income taxes, as the State of Alaska, the State of Wyoming, the State of Texas.

We have two other States, the States of Louisiana and North Dakota, who are collecting less than 2 percent of their income from income taxes, who basically have found ways to directly tax the rest of the country, and it would seem to me that if the administration is serious about creating tax fairness, we ought look not to this indirect burden which it sees on other States through the tax system, but look to the direct burdens where other States are collecting taxes from other parts of the country.

It also I think does show up from the Heritage Foundation testimony with the burden which is accurate. The District of Columbia does bear a much heavier tax burden. The rest of the country has not dealt fairly with the District on the Federal payment. I think that is clear argument as to why the Federal Government does have a great obligation.

Needless to say, however, I think what has happened here is that there has been a simplistic look at the country, and looking only at one aspect of our tax system. What is necessary to achieve fairness is to look at the total tax system, both the tax States charge on other residents because they happen to have natural resources or happen to have something else. Maybe, for instance, we should tax other States for keeping their Congressmen here in the District voting and working, which is just as much a natural resource of ours as an oil well is in the State of Oklahoma.

I would last say that I think we should look at the other effects that are happening in the tax proposals that will affect particularly areas like the District, and that is some of the other things.

When one talks about privatization of services, one has to look to the fact that the same time the Federal Government wants to cut out the opportunities for industrial and other revenue bonds, which have provided tax-exempt bond financing for areas where one wants to privatize services as might be with garbage collection or particularly in the District of Columbia, which will add to our burden, is in housing. That statement the Federal Government wants to cut off the deductibility of our taxes, it will have the effect of increasing the cost of providing housing programs which we certainly sorely need, because there are proposals to cut out revenue bond financing whereby we have tax-exempt bonds that support housing.

So I think what has to be done is to bring the arguments back to reality, and not allow the administration to put it on their turf that this is a battle between New York, and even New York and the District of Columbia and the rest of the country, because it is not. We need to make the tax situation fair, but not just at the expense of certain big city areas, which don't have the ability to tax certain things that other States do.

I thank you.

Mr. FAUNTROY. Thank you, Mr. Watson.

[The prepared statement along with attachments of Mr. Watson follow:]

TESTIMONY OF
MATTHEW S. WATSON
BEFORE THE
SUBCOMMITTEE ON FISCAL AFFAIRS AND HEALTH
OF THE
COMMITTEE ON THE DISTRICT OF COLUMBIA

Chairman Fauntroy, members of the subcommittee, I appreciate the opportunity of testifying before this subcommittee concerning President Reagan's proposal to eliminate the Federal tax deduction for state and local income taxes. I am concerned that the rationale expressed by the President that the deduction results in "low tax states subsidizing high tax states" will be accepted without question.

The argument of the President ignores the complexity of our system of fiscal Federalism. Because of differing economic advantages of the various states, many states have chosen to "export" the impact of their state taxes. Deductability for Federal purposes of state taxes is not a very efficient way to shift burdens. Indeed, as opposed to the President's contention that states with high taxes on their own residents have unfairly *indirectly* shifted the tax impact, the reverse is largely true. A number of states which maintain low local taxes have done so by their ability to pass their taxes *directly* to residents of other states.

This is especially true of states with large natural resource deposits, particularly with oil and natural gas production. For instance, the states of Alaska, Texas and Wyoming each have no state personal income taxes at all. This apparently low tax position is made possible, not by a particularly frugal government, as the

President would have you believe, but by the ability of each of these states to tax extraction of oil and gas at the wellhead. Such taxes are referred to as "severance" taxes. It is apparent that, since only a very few states have oil and gas deposits, the vast majority of such production is not used in those states, but is sold nationwide. The taxes charged are similarly not paid by the imposing state's own residents, but are exported to the rest of the country.

Eight states receive more than a quarter of their total revenue from severance taxes ultimately paid by other state's residents. (Alaska, Louisiana, Montana, New Mexico, North Dakota, Oklahoma, Texas and Wyoming)

These amounts are not small. In 1982, the state of Texas collected $2,278,601,000 in severance taxes, representing over 26% of the state's *total* tax revenues. That amount, which is greater than the entire District of Columbia budget, represents over $10 for every man, woman and child in the United States. The Texas tax is charged on natural gas at the rate of 7.5% of market value of gas produced. Based on purchases by Washington Gas in Texas, that means that during the winter months, my heating bill in the District includes over a dollar per month which is paid as a tax to the state of Texas.

The billion and a half dollars which Alaska receives from oil and gas production represents over 60% of its total revenues. Wyoming is a considerably smaller state than Texas and its revenues are less. Nevertheless, Wyoming receives more than half of its total state tax revenue from severance taxes on energy related production of oil, gas, coal and uranium. In 1982, Wyoming received $389,361,000 in these

taxes. That is an amount in excess of the District's Federal payment, and very clearly comes to Wyoming from the residents of the other 49 states and the District. These three states alone received a four billion dollar subsidy from the rest of the nation in 1982.

Although they do have income taxes, the states of North Dakota and Louisiana collect only 2.5 percent of their state and local revenues from individual income taxes. Louisiana supplements its local revenue with nearly a billion dollars of tax, including 7 cents per 1,000 cubic feet of natural gas and 12.5 percent of the value of oil. President Reagan should consider why I should "subsidize" the state of Louisiana when I fill my tank on Connecticut Avenue. It is interesting to note that, although I pay over 13 cents per gallon of direct state tax when I buy gasoline in the District, Maryland or Virginia in addition to the tax Louisiana, Texas, Alaska or Oklahoma gets from me, these states charge their own residents 8 cents a gallon or less when they fill up.

If the President is serious about his concern over tax shifting, he would do better to oppose the many taxes that resource rich states foist on other parts of the country, than to eliminate the deductability of state and local income taxes. If anything, resource rich states *should* be subsidizing resource poor states, rather than vice versa. But I think that the current proposal is more the product of vote counting than of economic wisdom.

I thank you again for this opportunity to testify. For the record, I have attached to my testimony tables showing state severance taxes and state income taxes.

TABLE 50--STATE SEVERANCE TAX RATES, 1982

State (FY 82 collections, $000) (as % of total state tax collections)*	Title and Application of Tax	Rate
Alabama ($61,470) (2.9%)	Iron Ore Mining Tax	3¢/ton
	Forest Products Severance Tax	Varies by species and ultimate use
	Oil and Gas Severance Tax	6% of gross value at point of production; 4% for wells producing less than 10 bbls./day
	Oil and Gas Production Tax	2% of gross value at point of production
	Coal Severance Tax	13.5¢/ton
	Coal and Lignite Severance Tax	20¢/ton
		County taxes are additional.
Alaska ($1,573,553) (61.9%)	Fisheries Business Tax	3% to 5% of fish value based on type of fish
	Oil and Gas Production Tax	Percentage of gross value determined annually--oil production for 1983 is 15% of gross value at point of production and varies by gravity of oil relative to its economic limit. Gas production tax for 1983 is 10% of gross value at point of production and varies by the economic limit factor.
	Regulation and Conservation Tax	1/6¢/barrel
Arizona (n/a)	Severance Tax	2 1/2% of net severance base of all minerals 1 1/2% of timber value
Arkansas ($29,715) (2.4%)	Natural Resources Severance Tax	Coal: 10¢/ton Bauxite, manganese, lead, ore: 1½¢/ton Gypsum: 1 1/2¢/ton Crushed stone: 2¢/ton Gas: 3/10¢/1,000 cubic feet Oil: wells producing more than 10 barrels/day - 5%; wells producing 10 or less barrels/day - 4% Timber: pine - 17.6¢/2,000 pound ton; all other - 12.5¢/2,000 pound ton Brine: $2.45/1,000 barrels All other minerals: 5% at point of severance
	Oil and Gas Conservation Tax	Not more than 25 mills/bbl. of oil nor more than 5 mills/1,000 cu. ft. of gas
California ($27,911) (.1%)	Oil and Gas Production Tax	Rate determined annually by Department of Conservation. The 1982 ratio was $.015/barrel of oil or per 10,000 cu. ft. of gas.
Colorado ($49,164) (2.9%)	Severance Tax	Metallic minerals tax is imposed at 3.25% of gross income exceeding $11 million. Molybdenum ore: 1½¢/ton Coal: 60¢/ton, plus a 1% increase for every 3% increase in the producers price index. Oil shale: 4% of gross value effective during 4th year of facility operation. Oil & gas: 2% if gross income is under $25,000; 3% if gross income is $25,000-$99,000; 4% if gross income is $100,000-$299,999; 5% over $300,000.
	Oil and Gas Conservation Tax	6/10 of 1(1/5) of market value for oil and gas.
Florida ($157,633) (2.6%)	Oil and Gas Production Tax	8% for oil and 5% for gas of gross value at point of production. Wells producing less than 100 bbls./day or producing oil by tertiary methods are taxed 5% of gross value at point of production
	Solid Minerals Tax	5% of market value at point of production for clay, gravel, lime, shells, stone, sand and rare earths. Phosphate rock: $1.67/ton Heavy Minerals: 84¢/ton

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TABLE 50--STATE SEVERANCE TAX RATES, 1981
(continued)

State ('82 collections, 9000) [as % of total state tax collections]*	Title and Application of Tax	Rate
Georgia [n/a]	Tax on Phosphates	Phosphate rock: $1/ton
Idaho ($2,517) [.4%]	Ore Severance Tax	2% of net value
	Oil and Gas Production Tax	Various of 3 mills/bbl. of oil and 3 mills/1,000 cu. ft. of gas
	Additional Oil and Gas Production Tax	2% of market value at site of production
Illinois [n/a]	Timber Fee	4% of purchase price
Indiana ($1,780) [less than .1%]	Petroleum Production Tax	1% of value
Kansas ($1,013) [.1%]	Oil and Gas Assessments	Various assessments for conservation
	Severance Tax	Oil and gas: 8% of gross value at point of production Coal: $1/ton Salt: 4¢/ton
Kentucky ($256,838) [10.3%]	Oil Production Tax	4 1/2% of market value
	Coal Severance Tax	4 1/2% of gross value
	Natural Resource Severance Tax	4 1/2% of gross value of all resources except oil and coal
Louisiana (1982,146) [31.4%]	Natural Resources Severance Tax	Gas: 7¢/1,000 cu. ft. (lower rates for smaller producers) Oil: 12.5% of value at point of severance Coal & ores: 10¢/2,000 pounds Stone, gravel & sand: 3¢/2,000 pounds Marble: 20¢/2,000 pounds Salt: 6¢/2,000 pounds Shells: 4¢/2,000 pounds Sulphur: $1.03/2,240 pounds Timber: varies from 2 1/4% to 6% of average stumpage market value
Maine (n/a)	Mining Excise Tax	Based on excise tax of a firm's facilities and equipment or gross proceeds
Maryland (n/a)	Mine Reclamation Surcharge	State levies 9¢/ton for coal mined by the open-pit method and counties levy 6¢/ton surcharge.
	Gas & Coal Severance Tax	Tax is levied by counties.
Michigan ($81,603) [1.7%]	Gas and Oil Severance Tax	5%, 6.6%, and 4% of gross cash market value of gas, oil, and oil from stripper wells and marginal properties. Additional fee not to exceed 1% of gross market value from previous year.
Minnesota ($118,609) [3.1%]	Iron Severance Tax	15% to 15.5% of value (depending on ore) minus credits
	Ore Royalty Tax	15% to 15.5% of royalty (depending on ore) minus credits
	Taconite, Iron Sulphides and Agglomerate Taxes	$1.25/ton plus a surcharge up to 1.6% based on percentage iron content of the ore
	Semi-Taconite Tax	10¢/ton plus 1/10 of 1¢/ton depending on iron content
	Aggregate Material Tax	Levied by counties

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TABLE 50--STATE SEVERANCE TAX RATES, 1981
(continued)

State (*81 collections, $000) [as % of total state tax collections]*	Title and Application of Tax	Rate
Mississippi ($117,013) [6.0%]	Oil and Gas Severance Tax	The greater of 6% of value or 6¢/bbl. of oil or 6% of value or 3 mills/1,000 cu. ft. of gas
	Oil and Gas Board Maintenance Tax	Not to exceed 20 mills/barrel for oil or 2 mills/cu. ft. for gas
	Timber Severance Tax	Varies depending on type of wood & ultimate use
	Salt Severance Tax	1% of value of amount produced
Missouri ($30) [less than .1%]	Assessment on Surface Coal Mining Permittees	30¢/ton for first 50,000 tons and 20¢/ton for the next 50,000 tons. No tax thereafter.
Montana ($149,361) [28.2%]	Coal Severance Tax	Surface mining tax varies from 12¢ or 20% of value/ton to 40¢ or 30% depending on quality of coal.
		Underground mining tax varies from 5¢ or 3% of value/ton to 12¢ or 6% of value.
	Metalliferous Mines License Tax	Progressive gross value tax from 0% to 1.5% of value
	Oil or Gas Producers' Severance Tax	License Tax: 6% of gross value until 1985 (5% thereafter) on oil; 2.65% of gross value of gas. Maximum conservation tax: 2/10 of 1% of market value/bbl. of oil and of each 10,000 cu. ft. of gas
	Micaceous Minerals License Tax	5¢/ton
	Cement License Tax	22¢/ton of cement, 5¢/ton of gypsum or plaster
	Resource Indemnity Trust Tax	$25 plus 1/2% of gross value over $5,000
Nebraska ($6,010) [.7%]	Oil and Gas Severance Tax	3% of the value (wells averaging 10 bbls./day or less, 2%)
	Oil and Gas Conservation Tax	Not to exceed 4 mills/$1 of value at the well-head
	Uranium Tax	2% of value in excess of $5 million gross value
Nevada (n/a)	Net Proceeds of Mine Tax	Property tax rate of place where mine is located
	Oil and Gas Conservation Tax	50 mills/bbl. of oil and 50 mills/50,000 cu. ft. of gas
New Hampshire ($45) [less than .1%]	Refined Petroleum Products Tax	1/10 of 1% on net proceeds of all petroleum products
New Mexico ($322,602) [30.8%]	Resources Excise Tax	All resources except oil, gas, and carbon dioxide taxed at various rates of 1/8% to 3/4%.
	Severance Tax	All resources except oil, gas, and carbon dioxide taxed at various rates of 1/8% to 2 1/2%; surface coal at 96.5¢/ton; underground coal at 93.1¢/ton.
	Oil and Gas Severance Tax	Oil is taxed at 3 3/4% of market value and gas at 14.7¢/1,000 cu. ft.
	Oil and Gas Privilege Tax	Rate is 3.15% of value.
	Natural Gas Processor's Tax	0.45% of value
	Oil and Gas Ad Valorem Production Tax	Varies
	Oil and Gas Conservation Tax	Oil, gas, geothermal energy, coal, and uranium taxed at 19/100 of value. Rate varies depending on amount in Oil and Gas Reclamation Fund.
North Carolina ($1,217) [less than .1%]	Oil and Gas Conservation Act	Not to exceed 5 mills/bbl. of oil nor 1/2 mill/1,000 cu. ft of gas (currently no producers in the state.)
	Primary Forest Product Assessment Tax	40¢ to 50¢/1,000 board ft. and 12¢ to 20¢/cord depending on type of wood and use.

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TABLE 50--STATE SEVERANCE TAX RATES, 1983
(continued)

State ('82 collections, $000) [as % of total state tax collections]*	Title and Application of Tax	Rate
North Dakota ($186,685) [35.0%]	Oil and Gas Production Tax	5% of gross value at well
	Coal Severance Tax	85¢/ton and 1¢/ton for every four-point increase in wholesale price index
	Oil Extraction Tax	6 1/2% of gross value at well
Ohio ($4,033) [.1%]	Resource Severance Tax	Coal and salt: 4¢/ton Limestone, dolomite, sand, and gravel: 1¢/ton Oil: 10¢/barrel Gas: 2.5¢/1,000 cu. ft.
Oklahoma ($742,700) [27.4%]	Oil, Gas and Mineral Gross Production Tax	Lead, asphalt, zinc, gold, silver and copper: 3/4% of gross value Oil and Gas: 7% of gross value, plus 0.085%/barrel of oil and 0.085% of gross value of gas Uranium: 5%
	Natural Gas and Casinghead Gas Conservation Excise Tax	7¢/1,000 cu. ft. less 7% of the gross value of each 1,000 cu. ft. of gas
Oregon ($50,480) [3.3%]	Forest Products Harvest Tax	2¾¢/1,000 board ft., plus 12¢/1,000 board ft. (levied July 1983 to July 1985) plus 15¢/1,000 board ft. on both west and east forest lands
	Severance Tax on Eastern Oregon Timber	5% of value; additional 7.5% tax on reforestation land which is reduced 1/4% each yr. after 1978
	Severance Tax on Western Oregon Timber	6.5% of value; additional 6% tax on reforestation land which is reduced 1/4% each yr. after 1978
South Dakota ($9,299) [2.8%]	Precious Metals Severance Tax	6% of gross yield
	Energy Minerals Severance Tax	4 1/2% of taxable value of any energy mineral
	Conservation Tax	2.4 mills of taxable value of any energy mineral severed and saved
Tennessee ($2,512) [.1%]	Oil and Gas Severance Tax	3% of the sales price
	Coal Severance Tax	32¢/ton (increases to 35¢/ton July 1984)
	Privilege Tax on Nuclear Minerals	Levied by local governments
Texas ($2,378,601) [26.1%]	Natural Gas Production Tax	7 1/2% of market value
	Oil Production Tax	4.6% of market value or 4.6¢/barrel, whichever is greater, plus 3/16¢/barrel
	Sulphur Production Tax	$1.03/long ton
	Cement Distributor's Tax	2 3/4¢/100 lbs.
Utah ($22,295) [2.3%]	Mining Occupation Tax	1% of value for metals, 2% of value for oil and gas
	Oil and Gas Conservation Tax	Up to 2 mills/$1 of wellhead value
Virginia ($1,280) [less than .1%]	Forest Products Severance Tax	Ranges from $1.15/1,000 board ft. for pine to 15¢/1,000 board ft. for cedar; various rates for other wood products. If revenue is not appropriated for reforestation purposes, then rates are reduced.
	Coal Surface Mining Reclamation Tax	2¢/ton of surface mined coal; 1¢/ton underground mined coal. Payment varies depending on fund level of the Coal Surface Mining Reclamation Fund
Washington ($46,123) [1.3%]	Uranium and Thorium Milling Tax	5¢/lb.
	Food Fish and Shellfish Tax	0.07% to 5% of the selling price depending on species plus 7% surtax

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TABLE 50--STATE SEVERANCE TAX RATES, 1983
(continued)

State ('82 collections, $000) [as % of total state tax collections]	Title and Application of Tax	Rate
Wisconsin ($837) [less than .1%]	Metalliferous Minerals Occupation Tax	Progressive net proceeds tax from 3% to 15%
Wyoming ($389,361) [51.1%]	Oil and Gas Production Tax Mining Excise and Severance Taxes	Not to exceed 4/5 mill/$1 value of the well Uranium: 5.5% of value Oil and gas: 6% of value Coal: 10.5% of value

* The information contained in parenthesis are the 1982 severance tax collections by state. The information contained in brackets are the 1982 severance tax collections as a percent of total 1982 tax collections. Total tax collections do not include revenue obtained from charges and miscellaneous sources. Figures do not include rents and royalties derived from natural resource production.

Source: ACIR staff compilations based on the Commerce Clearing House, State Tax Guide; Council of State Governments, The Book of the States, 1982-83, pp. 398-399; and Bureau of the Census, State Government Finances in 1982.

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TABLE 47—SUMMARY OF STATE GOVERNMENT INDIVIDUAL INCOME TAXES, PERSONAL EXEMPTIONS, STANDARD DEDUCTIONS, AND DEDUCTABILITY OF FEDERAL INCOME TAXES, 1983

[As of October 1. Only basic rates, brackets and exemptions are shown. Local income tax rates, even those mandated by the state, are not included. Taxable income rates and brackets apply to single individuals; other schedules may be used for married taxpayers filing jointly or separately and/or heads of households in California, Georgia, Hawaii, Idaho, Kansas, Maine, New Mexico, Oklahoma, Oregon, Utah, and West Virginia.]

STATE	Taxable Income Rates (range in percent)	TAXABLE INCOME BRACKETS		PERSONAL EXEMPTIONS			SIZE OF STANDARD DEDUCTION 1/			Federal income tax deductable 2/
		Lowest amount under	Highest amount over	Single	Married-joint return	Dependents	Percent	Single	Married-joint return	
AL+	2.0 - 5.0	$ 500	$ 3,000	$1,500	$ 3,000	$ 300	20%	$2,000	$4,000	yes
AK				NO STATE INCOME TAX						
AZ 3/	2.0 - 8.0	1,017	6,102	1,759	3,518	1,056	17	880	1,759	yes
AR	1.0 - 7.0	2,999	25,000	4/ 17.50	4/ 35	4/ 6	10	1,000	1,000	no
CA 3/	1.0 - 11.0	4,600	25,430	4/ 38	4/ 76	4/12	X	1,510	3,020	no
CO 3/	2.5 - 8.0	1,415	14,153	1,203	2,406	1,203	X	1,415	1,415	yes
CT*				VERY LIMITED INCOME TAX						
DE+	1.4 - 13.5	1,000	50,000	600	1,200	600	10	1,000	1,000	yes*
DC	2.0 - 11.0	1,000	25,000	750	1,500	750	10	1,000	1,000	no
FL				NO STATE INCOME TAX						
GA	1.0 - 6.0	750	7,000	1,500	3,000	1,500	1/15	2,300	3,000	no
HI	2.25 - 11.0	800	30,800	1,000	2,000	1,000	X	800	1,000	no
ID	2.0 - 7.5	1,000	5,000	same as federal						no
IL	3.0	— FLAT RATE —		1,000	2,000	1,000	X	X	X	no
IN+	3.0	— FLAT RATE —		1,000	2,000	500	X	X	X	no
IA+* 3/	.5 - 13.0	1,023	76,725	4/ 19	4/ 38	4/ 14	1/ 15	1,200	3,000	yes
KS	2.0 - 9.0	2,000	25,000	1,000	2,000	1,000	1/ 16	2,400	2,800	yes
KY+	2.0 - 6.0	3,000	8,000	4/ 20	4/ 40	4/ 20	X	650	650	yes
LA	2.0 - 6.0	10,000	50,000	4,500	9,000	4,500	—	same as federal	—	yes
ME 3/	1.0 - 10.0	2,044	25,000	1,000	2,000	1,000	16	2,453	2,862	no
MD+*	2.0 - 5.0	1,000	3,000	800	1,600	800	13	1,500	3,000	no
MA*	5.0	— FLAT RATE —		2,200	*	700	X	X	X	no
MI+*	6.35	— FLAT RATE —		1,500	3,000	1,500	X	X	X	no
MN 3/*	1.6 - 16.0	672	36,925	4/ 68	4/ 136	4/ 68	10	2,268	2,268	yes
MS	3.0 - 5.0	5,000	10,000	6,000	9,500	1,500	15	2,300	3,400	no
MO+	1.5 - 6.0	1,000	9,000	1,200	1,200	400	X	2,300	3,400	yes
MT 3/	2.0 - 11.0	1,200	42,000	960	1,920	960	20	1,800	3,600	yes
NE		20% of federal income tax liability for tax year 1983								
NV		NO STATE INCOME TAX								
NH*		VERY LIMITED STATE INCOME TAX								
NJ*	2.0 - 3.5	20,000	50,000	1,000	2,000	1,000	X	X	X	no
NM	.7 - 7.8	1,000	100,000	same as federal						no
NY+*	2.0 - 14.0	1,000	23,000	800	1,600	800	17	2,500	2,500	no
NC	3.0 - 7.0	2,000	10,000	1,100	2,200*	800	10	550	*	no
ND*	2.0 - 9.0	3,000	50,000	1,000	2,000	1,000	X	2,300	3,400	yes
OH+*	.5 - 5.0	5,000	100,000	1,000	2,000	1,000	X	X	X	no
OK*	.5 - 6.0	1,000	7,500	1,000	2,000	1,000	1/15	2,000	2,000	yes*
OR*3/	4.0 - 10.0	500	5,000	4/ 85	4/ 170	4/ 85	13	1,500	1,500	yes*
PA+*	2.45	— FLAT RATE —		X	X	X	X	X	X	no
RI		26.75% of federal income tax liability for tax year 1983								
SC 3/	2.0 - 7.0	2,000	10,000	800	1,600	800	10	1,000	2,000	yes*
SD		NO STATE INCOME TAX								
TN*		VERY LIMITED STATE INCOME TAX								
TX		NO STATE INCOME TAX								
UT	2.75 - 7.75	750	3,750	750	1,500	750	1/15	2,000	2,000	yes
VT		26% of federal income tax liability for tax year 1983 (with special allowances)								
VA	2.0 - 5.75	3,000	12,000	600	1,200	600	15	2,000	2,000	no
WA		NO STATE INCOME TAX								
WV*	2.1 - 13.0	2,000	200,000	700	1,400	700	10	1,000	1,000	no
WI*3/	3.4 - 10.0	3,900	51,600	4/ 20	4/ 40	4/ 20	X	2,300	3,400	no
WY		NO STATE INCOME TAX								

(continued on next page)

U.S. Advisory Commission on Intergovernmental Relations

TABLE 47--SUMMARY OF STATE GOVERNMENT INDIVIDUAL INCOME TAXES, PERSONAL EXEMPTIONS, STANDARD DEDUCTIONS, AND DEDUCTABILITY OF FEDERAL INCOME TAXES, 1983
(continued)

X Not applicable.
◆ States in which one or more local governments levy a local income tax.

1/ The lesser of 1) the percentage indicated, multiplied by adjusted gross income or 2) the dollar value listed. Of states that have a maximum standard deduction with a percent of A.G.I. provision, only IA, GA, KS, and UT have a minimum deduction as well.

2/ A state provision that allows the taxpayer to deduct fully the federal income tax reduces the effective marginal tax rate for persons in the highest state and federal tax brackets by approximately one-half the nominal tax rate--the deduction is of a lesser benefit to other taxpayers.

3/ Indexed by an inflation factor. CO, IA, OR, SC and WI have suspended or postponed indexing through at least 1983.

4/ Tax credit.

NOTES:

CT: There is an income tax on interest and dividend income only. The rate of this tax ranges from 6% of interest and dividend income for taxpayers with an A.G.I. of $50,000-$59,999 to 13% of such income of taxpayers with an A.G.I. over $100,000. Capital gains are taxes at 7% after an exemption of $100 is applied.

DE: Federal income tax deduction limited to $300 ($600 married).

IA: Tax cannot reduce after-tax income of taxpayer to below $5,000.

MA: Rates includes a 7.5% surcharge which has been in effect since 1976. 10% (flat rate) imposed on net gains, interest and dividends. Tax cannot reduce after-tax income to below $1,000 ($5,000 married). Exemption is the smaller of $4,400 or $3,000 plus the income of the spouse having the smaller income.

MI: January 1984 the rate will drop to 6.1% and on January 1985, it will drop to 5.35%. Lower rates are possible depending on the state unemployment rate and state accounting practices.

MN: A 10% surcharge on the liability is also additional.

NH: There is a 5% tax on interest and dividends (excluding income from savings bank deposits) in excess of $1,200 ($2,400 married).

NJ: No taxpayer is subject to tax if gross income is $3,000 or less ($1,500 married, filing separately).

NY: No tax due from individuals with an adjusted gross income of $2,500 or less or married head of household or surviving spouse of $5,000 or less.

NC: An additional exemption of $1,100 is allowed the spouse with the smallest income. Joint returns are not allowed. An additional $550 is allowed a married woman with separate income.

ND: Taxpayers have the option of paying a tax of 10.5 percent of the taxpayers adjusted federal income tax liability.

OH: For tax year 1983, there is an additional 83.3% surcharge. After January 1984, there is a permanent 90% rate increase. Beginning in 1983 tax year, taxpayers may choose between a $1,000 personal income exemption or a $650 personal exemption plus a $20 tax credit.

OK: These tax rates and brackets apply to single persons not deducting federal income tax. For individuals deducting federal income tax rates range from .5 percent of the first $1,000 to 17 percent on income over $49,000.

OR: An 8% surcharge on tax liability is also additional. Federal tax deduction limited to $7,000 ($3,500 married, filing separately).

PA: The tax rate is 2.35% beginning July 1984.

SC: Federal tax deduction limited to $500.

TN: Interest and dividends taxes at 6%; dividends from TN corporations taxed at 4%.

WV: A 12% surcharge on taxable income over $10,000 is also additional.

WI: A 10% surcharge on tax liability is also additional.

Source: ACIR staff compilations based on Commerce Clearing House, State Tax Reporter.
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Mr. FAUNTROY. We will hear now from Mr. Nathan and then there will be a number of questions of the panel.

STATEMENT OF IRV NATHAN

Mr. NATHAN. Thank you very much, Mr. Chairman. I am appearing here today on behalf of the American Jewish Congress. I have submitted a full statement which I would request be included in the record. I will simply summarize it very briefly.

Mr. FAUNTROY. Without objection the statement is included in the record. You may now proceed to summarize.

Mr. NATHAN. Thank you, Mr. Chairman. As you are aware, the American Jewish Congress is a national organization which is designed to protect the civil, political, economic rights and religious rights of all Americans, and to promote democracy. I was pleased to be in attendance, Mr. Chairman, when you recently addressed our local chapter, and enumerated the various issues on which we have a common interest, and this clearly is one of them.

When I express the views of the American Jewish Congress, I am expressing the views of the national organization and not limited to its impact on the District of Columbia or the local chapter, and it is the organization's view that deductibility of State and local taxes is a very important concept in permitting States and localities throughout the country to meet the needs of the citizens in those jurisdictions, and that the elimination of that deductibility will have profound impacts both on the delivery of services, on demographic changes, and changes in jurisdictions, and also with respect to relations between peoples in communities such as the District of Columbia, where obviously there will be pressure for reduction in services, where there will be less revenues, there could be increased tensions for reduced resources, which would not serve the quality of life here or in other communities.

Let me focus on one other issue in particular that is of concern to the American Jewish Congress, and that is the quality of education. It is very important to this organization to have a very sound and solid public school education system. I heard the Heritage Foundation talk about privatization of services. Obviously, at least a third or more than a third of the expenditures of State and local governments are with respect to public education. No one is suggesting the privatization of those kinds of services. If you put pressure on State and local governments to reduce their expenditures, which clearly will happen, as Mr. Dearborn has suggested, and others, if there is the loss of deductibility, the education system is going to suffer, and that is not going to benefit anyone in this country, no matter where they live.

There is an additional point there I think that needs to be focused on, and it is really the main political point here. This administration constantly wants to put the responsibility for delivery of services elsewhere. They want to put it on State and local governments. They also want to put it on charitable institutions, and at the same time, in addition to trying to take away the deductibility, they are talking about serious limitations on the deductibility of charitable contributions, the lowering of the high tax rates, and the limitations on what deductions will be allowed for charitable

deductions will obviously have an impact on charitable institutions to provide services and also the lack of deductibility will provide that loss to State and local governments.

It seems to us that the responsibility should be with the governments but they should have the opportunity to have the resources to fulfill those responsibilities, and not have the Government, the Federal Government, in the guise of reform and tax simplification, make profound differences in where its services can be provided and where the revenues can be for that.

With respect to the District of Columbia government in particular, obviously, where we have no representation, no voting representation in the Senate or in the House, where this money will flow from the District to the Federal Government, there obviously will be less control that District of Columbia citizens can have over the money that would be lost if there is the loss of deductibility for State and local taxes.

For all of these reasons, we urge you and other members of this committee to vote against the notion of the loss of deductibility of State and local taxes, and to examine all features of this tax reform bill by the administration, to avoid the kind of profound changes that we think are implicit in some of these proposals.

Thank you.

[The prepared statement of Mr. Nathan follows:]

TESTIMONY OF THE AMERICAN JEWISH CONGRESS

Mr. Chairman, my name is Irvin Nathan. I am pleased to appear here today in my capacity as the Chairman of the National Capital Region Board of Trustees of the American Jewish Congress. I am a partner in the Washington law firm of Arnold and Porter and a resident of the District of Columbia. The views that I am expressing here today are those of the American Jewish Congress.

The American Jewish Congress is a national membership community relations organization founded in 1918 by Rabbi Stephen S. Wise, Supreme Court Justice Louis D. Brandeis, and other distinguished Americans to project the religious, civil, political and economic rights of all Americans and to promote the principle of democracy.

I appear before you today representing our national membership of over 40,000 and, specifically, the over 2,500 members of the National Capital Region. Locally, we continue to work within the community to improve intergroup relations with the many minorities that reside in our city. In fact, recently we were honored to have Chairman Fauntroy join us to discuss the many issues of concern to both the Black and Jewish communities.

The American Jewish Congress recognizes the need for tax reform and tax simplification. We are, however, greatly concerned with the impact of several provisions included in the Administration's proposed tax reforms. The issue discussed today, the elimination of state and local tax deductibility from federal taxes, is one of our major concerns.

Since the initiation of income tax deductibility of state and local taxes has been an accepted principle. The expressed purpose was to avoid the burdensome effect of double taxation; taxes should not be paid on taxes, only on disposable income.

The loss of deductibility would, we fear, have a significantly negative impact on social services and our schools. When coupled with other aspects of the tax reform proposal—such as limitations on charitable deductions—state and local governments, and private institutions, could be deprived of the ability to meet the needs of segments of society which the present Administration is unwilling to have met by the federal government.

The elimination of state tax deductibility would inevitably lead to deep cuts in social services. The repeal would force states and localities to cut services by 47 cents for every dollar the Treasury gains from eliminating deductibility. By 1990 this would mean a nationwide cutback of $19 billion in basic services including health, education, safety and housing.

According to the Advisory Commission on Intergovernmental Relations, state and local governments will be pressured to cut spending by up to 8 percent. Residents

will, understandably, want a corresponding tax decrease at a time when it is increasingly necessary to raise revenues. States and municipalities will hesitate pushing through measures to raise revenues, and in fact will cut taxes to prevent the potential population shifts. If local communities do not respond to pressures to reduce local taxes, and offset the loss of deductibility, we may well have a significant population of higher income residents moving to areas with lower taxes, leaving lower income residents unable to finance basic services. This would hit the high tax areas, including the District of Columbia, hardest. The effect will be to punish residents of highly taxed communities for serving the poor and the underprivileged, while forcing state and local governments to cutback or eliminate programs in these areas to reflect "the new fiscal realities."

As a community relations agency, an organization founded to promote fairness and justice for all Americans, we are particularly concerned with how the proposed changes will effect not only the direct welfare of the minority and disadvantaged segments of our society, but how they will effect the relations between these communities. Members of these communities who receive both state and local financial assistance, along with charitable assistance, will find themselves competing for funds and services with other minority groups while desperately needed sources of revenues decrease.

The American Jewish Congress, following our Judaic heritage, has been an active advocate for educational excellence. We take great pride in our history of pursuing, both through legislation and through the courts, an independent and strong public school system. The elimination of state deductibility would pose a grave danger to the vitality and independence of local public schools. Tax sharing for education has been embodied in the tax code since its inception in 1913, and this deduction is, indirectly, the largest federal contribution to education. Almost 36 percent of all state and local expenditures are earmarked for education. Of the $19 billion which will be lost in state and local revenues $6.5 billion would be taken from education. Combined with the proposed elimination of some charitable deductions, education would be sharply and adversely affected.

An American Federation of Teachers' survey found that loss of the standard tax deduction would cost local governments an average of $271 for each student. For the District of Columbia, the figure is $440 per student.

As former Senator Jacob Javits recently wrote, "Ending deductibility would damage the ability of every state and locality, including school districts, to raise revenues at precisely the time that the Administration's new federalism is cutting back on federal expenditures and shifting greater responsibility to the state and local level."

The District of Columbia, with the second highest rate of deductibility for local taxes, has an average deduction of $2,059. Every April 15th, D.C. residents gather to protest taxation without representation. It is particularly unfair that we should be subjected to double taxation without representation.

We agree that it is time to reform our present tax system. It is our contention, however, that the elimination of state deductibility for local taxes is unjust. The Reagan Administration has often expressed its interest in shifting responsibility from the national level to local governments. When the loss of deductibility is joined with earlier and recently proposed budget cuts, what will occur is a shifting of responsibilities without the financial means to provide for their implementation. Social and educational services, already reduced to offset previous budget cuts, cannot withstand any further reductions of pressures.

We strongly urge the members of this committee to support the retention of deductibility for state and local taxes, and to scrutinize the overall proposals, including the limit on charitable deductions, to ensure that fairness and equity for all citizens are not sacrificed in the name of tax reform and tax simplification.

We approach the tax reform debate guided by Rabbi Stephen S. Wise who urged us to seek "not charity but justice."

Mr. FAUNTROY. Thank you, gentlemen, each of you, for your contributions to our hearing today. I want to take advantage of your breadth of knowledge of the impact of the entire proposal by posing first just some general questions that have puzzled me.

One of the assessments that we have heard is that the administration's proposal will pit some States against other States. Is that true in your view?

Mr. DEARBORN. Mr. Chairman, as I indicated, I am not sure it will pit States against each other, but it will change their relative tax position to each other, and certainly will disrupt, as I indicated, any equilibrium that they have reached in their tax systems. What you have is easy to see in this metropolitan area. For years we have had higher tax burdens in the District of Columbia than in the surrounding suburban jurisdictions, for most people.

There are some cases where that might not be true. People accept those. They would rather live in the District of Columbia because they like the easier commuting. They like the neighborhood, for whatever reason. That is going to be changed. The difference in taxes that they have to pay to get the amenities in the District would go up.

Now, that doesn't mean Virginia and the District are going to start battling each other, but it means some people will decide perhaps, "I guess I would rather not pay that much extra taxes for the benefit of living in the District. I think I will live in Arlington County; it is only across the bridge, and I will sacrifice some of the things I would like to have." So to that extent, to that extent there would be competition between the States, but I don't think it would be because Virginia would set out to try to attract District residents. It would just happen as a matter of course.

Mr. WATSON. I think the other thing that will happen is that there will be more imagination used by the District and by all States to find those things that they can tax which will be exported to other States or will come into the business climate.

I think we can see that when the determination gets made, for instance, to build toll roads or not to build toll roads may very well be based on how much they think will be on out-of-State people coming through, and how much then will be borne by business. I think this is sort of unfortunate that governments will spend so much of their time trying to structure themselves for these tax purposes as opposed to trying to offer the services that we should be offering to the people.

Mr. NATHAN. I think there will be some pitting of State against State and jurisdiction against jurisdiction, and I think it is sort of the worst kind of competition, because what it is going to suggest is that States are going to have to try to reduce their taxes and therefore reduce services, and it is going to be the question of who is providing the least service will be those who are then trying to attract certain people who can afford living without making those tax payments. It will then leave poorer people who are not in a position to change jurisdictions to remain with shrinking tax bases, and then with shrinking services, and I think that is exactly the wrong kind of competition that we need in this country.

Mr. FAUNTROY. Is it true that the proposal would shift resources from the Northeast and Midwest to the South and Southwest and the Far West?

Mr. WATSON. There would be some of this, partly because of the demand for services that are necessary in the older communities. Newer communities have generally had much less of an impact of needing to serve the aged, needing to serve poverty populations, because they have had growing industry attracting people, and I think what we will find then is that States will continue to have

tax burdens because they have high tax needs in the Frost Belt that has declining industry, and that also has an aging population.

One can see this, interestingly, within the Washington area as it is changing, if you look at expenditures in suburban areas in the 1950's and 1960's and early 1970's. There was very little need for aged services. You look at it now and we have found that the suburbs have grown their own aged, that the people who in the 1950's were 35 and moved to suburban areas, lo and behold, are now 65 and are now needing these services.

One can see that in the relative budgets of the whole metropolitan area, but I think for a while we will continue to see that in the rapidly growing areas which don't have the same needs, which again is something that we should met as a nation and not simply meet as individual States.

Mr. DEARBORN. Mr. Chairman, as I indicated in my testimony, the proposal is so complex, there are over 100 changes. It takes 461 pages to describe them. I don't think we can reach any positive conclusion at this point. I have been trying to examine everything that has come out that has been available, and there are so many things going in so many different directions in this that it is almost on a jurisdiction basis rather than a regional thing. I think you will be able to find places in the South which will be very severely disadvantaged. You will find places in the North which will gain advantage.

The way the features other than the loss of deductibility play out is extremely complex. A service-oriented area like the Washington area may find very little adverse tax consequences on the $26 billion increase on the corporate side, whereas an area that has heavy manufacturing, for instance Birmingham, AL, might be very disadvantaged by that corporate tax shift. So I think we have to be very careful with the limited information we have on drawing those types of regional conclusions.

Mr. FAUNTROY. Is it not true, however, that those who have their tax rates reduced from 70 percent to 50 percent in 1981, who now have their tax rates reduced from 50 percent to 35 percent, will be making out like bandits?

Mr. WATSON. I think some of that——

Mr. FAUNTROY. Mr. Dearborn.

Mr. DEARBORN. Well, I can't answer that question. To generalize about taxpayers on this is extremely difficult. I have tried to do a number of different sample taxpayers. When we get into the very high-income people, we run into the problem we don't know what tax shelters they have been using that they won't be using under the proposal. Now, tax-exempt bonds will still be available.

A lot of very wealthy people may try to crowd into those shelters. If they all try to get in the door at once, the shelter value is going to go down, and it may in fact become not much of a shelter at all, because there are too many people trying to use it. Things like this I frankly have given up on.

Now, perhaps when Henry Aaron was here, some of the bigger national economists, they will be able to figure this out, but at this point a simple look at it says, yes, that dropping of the bracket will definitely immensely improve the position of very wealthy people, but we just have this whole tax shelter business that we have to

take into account, and I don't know where we are going to come out on that.

Mr. FAUNTROY. I have the bad habit of suggesting these things empirically myself. I have often commented on the fact that I have seen every inauguration since President Roosevelt's fourth inauguration, and I was flabbergasted, quite frankly, by the fact that the 1981 inauguration we had to close down National Airport to commercial traffic because of all the Learjets that were flying in, private jet planes that were coming in, and that we had to go as far north as New York and as far south as Raleigh, NC, to get enough limousines to accommodate those who do not trouble themselves about taxes. It only occurred to me after I saw the ERDA package that maybe they knew something that was coming that was worth celebrating.

But that aside, let's get back to more serious local things here.

Mr. WATSON. There is another what I think will be a local problem and part of it comes from Mr. Dearborn's research on charitable giving, that there are going to be two effects: One is that with corporate taxes to some extent, as they should be, being increased, it will make it easier for corporations to give. But we are not a big jurisdiction for corporations to be making charitable giving, and with at the same time the lowering of tax brackets for individuals will make it less attractive for individuals to be giving charitable giving, which is the backbone of the District's local charitable giving. I think we are going to see at the same time the District government facing serious pressures, because of the tax proposals, in meeting governmental needs, that the needs may increase because nonprofits will have less of an ability to meet the needs, because we don't have the corporations to contribute, and there will be less incentive for individuals to contribute.

Mr. NATHAN. Mr. Chairman, I think that two points emerge from Mr. Dearborn's statistics, where he makes it clear there are some winners and there are some losers, and there are some things that cannot be determined at this point. One is that for the District of Columbia, so far as I have heard in all of the testimony this morning, there are not any significant benefits to the loss of deductibility. All of the pressures, all of the implications, all of the effects are likely to be adverse.

With respect to the national interest here, it seems to me that it is too speculative to see that there are advantages to what is billed as tax simplification and tax reform. In fact, if it takes 460 pages to explain tax simplification, and if some of the best trained economists cannot predict what are the effects there are going to be from this package, it would urge, I think considerable caution before endorsing a package which certainly in this jurisdiction and in others will have serious adverse effects.

Mr. FAUNTROY. It has generally been stated as well that middle-income people generally take a beating relative to the poor and the more affluent in the country. What would be the impact on middle-income residents from the District on our city's economic base?

Mr. DEARBORN. I think the exodus might be caused not so much by what the Federal Government would do as by what the District government might have to do. I think the District government would have to shift, as I indicated, more of its burden from the

higher incomes to the middle incomes in the city, and I think that would be oppressive on middle incomes.

Mr. FAUNTROY. I realize now that you really answered that question in the course of your discussion. In 1982, President Reagan placed a great deal of emphasis on his New Federalism proposals, which were intended to place greater responsibility on the States. In your opinion, how does this tax proposal compare with New Federalism? Is it compatible or conflicting?

Mr. WATSON. It I think to some extent conflicts, but I think it indicates an idea for the administration not just to put the burden on the States, but indicates that we are not a compassionate society and should not be meeting the burdens at all. I think that the more true intent is coming out. There is a push I think to try to get the governments at all levels to stop providing services, which I think is a disastrous course.

Mr. DEARBORN. I have a simpler answer, I think. I believe the tax reform proposal was prepared by Treasury. I don't think Treasury had any particular interest or concern about New Federalism when they prepared it, and it seems to be that type of a proposal, a Treasury proposal, and not a federalism proposal.

Mr. FAUNTROY. Gentlemen, I want to thank you so much for your testimony and the care with which you have prepared very good testimony that should be helpful to us in passing on to our colleagues on the Hill the impact on the District of Columbia, our Nation's Capital, and also helping our own local government to prepare for the possibility that this may in fact become law.

The Subcommittee on Fiscal Affairs and Health therefore has heard testimony regarding the administration's tax proposals to repeal the State and local tax deduction; and for a majority of the testimony presented here today, it appears that we have to agree that the District of Columbia would be adversely affected. While the District is a high-tax municipality, its tax system is highly progressive. Any changes as a result of the administration's proposals would serve to place a greater tax burden on those who can least afford it. Furthermore, the District might be forced to drastically reduce services for residents.

What also disturbs me about the tax proposals is its definition of a family as a one wage-earner spouse and two children. The Mayor made a significant point in there. This definition of a family allows the administration to claim tax savings for itemizers. Yet testimony presented here today shows that definition does not apply to the District of Columbia, and may not apply to many of the States.

The Committee on Ways and Means will hold hearings on this subject on Wednesday, July 17, next week, and I hope that all of us testifying here today will take particular note of what transpires at that time, and I ask the staff of the subcommittee to monitor those hearings, and to follow the work of the Ways and Means Committee for purposes of assessing the impact of the committee's actions on the District of Columbia and its residents, that I may share with those of you who have obviously a very strong interest in this whole subject.

Thank you again, and with that we call the hearing to a close.

[Whereupon, at 11:50 a.m., the subcommittee adjourned.]

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